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Markets, Courts, and the Brave New World of Bankruptcy Theory

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MARKETS, COURTS, AND THE BRAVE NEW WORLD OF BANKRUPTCY THEORY

DAVID A. SKEEL, JR.*

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INTRODUCTION

Six years ago, a bankruptcy scholar's suggestion that Chapter 11, the Bankruptcy Code's corporate reorganization chapter,¹ should be abolished would have interested almost no one except perhaps a few other academicians.² Even then, at the height of the takeover boom, many

1. Chapter 11 comprises §§ 1101-1174 of the Bankruptcy Code, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (1988)). Hereinafter, Bankruptcy Code provisions will be cited as, "Bankruptcy Code § ____."

2. Douglas Baird made precisely this suggestion. See Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986) [hereinafter Baird, *Corporate Reorganizations*]. This article and his work with Thomas Jackson precipitated a much-cited debate between Baird and Elizabeth Warren, see Elizabeth

observers predicted that Chapter 11 would be increasingly important for large, high profile corporations. But nearly everyone assumed, with a few caveats, that Chapter 11 worked just fine. What a difference a year or two makes.

In the intervening time, lawyers, business people, and the general public have witnessed a series of highly visible companies disintegrate in bankruptcy. There have been successful reorganizations, of course, but many see cases like the Eastern Airlines bankruptcy as more the order of the day. Eastern had a somewhat shaky track record when it entered Chapter 11, but had been a prominent airline for many years. Eastern deteriorated rapidly and was eventually liquidated.³ Another major company, LTV Corporation, entered Chapter 11 several years before Eastern and, after more than six years, still has not seen the light of postbankruptcy day.

In a sense, then, Michael Bradley and Michael Rosenzweig simply captured the spirit of the moment when they boldly proclaimed in an article published in March 1992 that the time to eliminate Chapter 11 had come.⁴ Their broadside was particularly timely, coming during a period of intense public anger at managers' lavish wages and lifestyles, because, in addition to arguing that Chapter 11 does more harm than good, Bradley and Rosenzweig conclude that managers are to blame. Even better, they purport to back up this thesis with extensive empirical proof.⁵

Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987); Douglas G. Baird, *Loss Distribution, Forum Shopping and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987), but did not create nearly so great a stir in the popular media and the bankruptcy bar as the Bradley and Rosenzweig article discussed below.

3. See, e.g., Claudia MacLachlan, *Blame Flies in Demise of Airline*, NAT'L L.J., May 27, 1991, at 1, 35-36.

4. Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992).

5. As both Lynn LoPucki and Elizabeth Warren point out in new commentaries on the Bradley and Rosenzweig article, the empirical analysis proves problematic on inspection. Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79 (1992); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437 (1992). Bradley and Rosenzweig compare the pre and postbankruptcy stock and bond values of publicly held firms that filed under the former Bankruptcy Act, to those that have filed under the 1978 Bankruptcy Code. They conclude from their data that firms filing Chapter 11 petitions under the Bankruptcy Code were worth significantly more on the filing date, but lost a much higher percentage of their value while in bankruptcy. Bradley & Rosenzweig, *supra* note 4, at 1076-77. However, Bradley and Rosenzweig fail to consider the substantial differences between Act and Code debtors. Moreover, courts may well have permitted greater deviations from the absolute priority rule in cases under the old Act. LoPucki, *supra*, at 94. Warren questions the accuracy of their data set and suggests several alternative explanations for their results. Warren, *supra*, at 455-67.

If the current reorganization regime does not work, the obvious question that arises is, what should be done? Bradley and Rosenzweig would replace Chapter 11 with a "contingent equity" regime providing for the automatic cancellation of a corporation's stock in the event of any default. At least four other commentators have offered their own alternatives to Chapter 11, ranging from Barry Adler's modified version of the Bradley and Rosenzweig proposal,⁶ to Doug Baird's consideration of the efficacy of mandatory auctions,⁷ and James Bowers's suggestion that we should jettison Chapter 11 altogether and simply leave the parties to their own devices.⁸ The one thing the proposals have in common is their insistence on the need for a much more market-oriented regime.

A central purpose of this Article is to bring the various proposals together and to scrutinize each in some detail. I begin this process in Part I with a brief overview of the proposals and the theoretical background from which they have emerged. Having introduced the proposed alternatives to Chapter 11 in Part I, I examine each in turn in Part II. The discussion reveals that each of the proposals has significant flaws and suggests that none is clearly superior to Chapter 11 for all kinds of debtors.

In Part III, I shift gears and address the more practical question of whether any of the proposals, or perhaps a different proposal, is likely to be adopted by Congress. The standard public choice story suggests that managers and members of the corporate and bankruptcy bars are sufficiently well organized and have so much at stake, that they will thwart any attempted reform of Chapter 11. The problem with this story is that it not only ignores the influence of interest groups such as institutional investors, but it also fails to consider the importance of widespread populist antipathy toward both managers and the corporate and bankruptcy bars. Although my public choice analysis suggests that reform is at least possible once these crucial factors are taken into account, I use a modified version of Karl Polanyi's thesis in *The Great Transformation*⁹ to argue that none of the current proposals is likely ever to make it through Congress. Polanyi posited that the state will inevitably act to prevent the market from becoming self-regulating. With the limited exception of mandatory auctions, all of the proposals aspire to self-regulation; in the search for a pure market solution to the problems of Chapter 11, each underappreciates the importance of the courts in the

6. See *infra* notes 32-34 and accompanying text.

7. See *infra* note 28 and accompanying text.

8. See *infra* notes 35-37 and accompanying text.

9. KARL POLANYI, *THE GREAT TRANSFORMATION* (1944).

insolvency context¹⁰ and, as a result, would almost certainly prove unattractive to Congress.

The first three parts of the Article are largely destructive, raising questions about each of the new proposals and then casting doubt on the suggestion that any might one day be adopted. I change tacks a final time in Part IV. In that part, I argue that while the proposals themselves should not be adopted, they do suggest ways in which the current bankruptcy laws should be radically amended. I contend in particular that the drafters should split Chapter 11 into two chapters, one dealing with close and the other with nonclosely held corporations. My proposal is, in a sense, a call to return to the format of the old Bankruptcy Act, and an endorsement of at least one aspect of an early version of the bankruptcy legislation that nearly passed Congress in 1992. Both contemplated separate treatment of different kinds of corporations. Unfortunately, both were deeply flawed. I conclude by showing the problems of each, and why my two corporation system would improve on both.

I. BANKRUPTCY THEORY AND THE EMERGING NEW ORDER

The proposed alternatives to Chapter 11 can and perhaps should be seen as the second generation of the path-breaking work on bankruptcy theory done by Douglas Baird and Thomas Jackson in the 1980s. I therefore begin by describing Baird and Jackson's creditors' bargain model of bankruptcy, and the critiques that eventually led to the new proposals. This paves the way for a short synopsis of each of the proposals at the end of this part.

A. *The Creditors' Bargain Model*

Bankruptcy dramatically changes relationships among a debtor and its creditors. In the absence of bankruptcy, an individual creditor's rights against the debtor are governed by contract, together with (mostly) state debt collection laws. Bankruptcy calls a halt to these individual

10. I refer to the "insolvency regime" or the "insolvency context" throughout the Article and often use these terms as synonyms for Chapter 11, bankruptcy, or one of the proposed alternatives to Chapter 11. Strictly speaking, the term is not accurate, since solvent firms are not precluded from filing a Chapter 11 petition. Nevertheless, the term is convenient, and most firms that file for bankruptcy are in fact insolvent. See, e.g., Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 141-43 (1990) [hereinafter, LoPucki & Whitford, *Bargaining over Equity's Share*].

The creditors' bargain model quickly assumed an almost canonical status and, in consequence, became the subject of immediate and sustained critical attention. Much of the initial questioning of the model stemmed from the observation that, as a descriptive matter, bankruptcy deviates markedly from the creditors' bargain ideal. Rather than preserving the parties' state law entitlements (other than a creditor's right of immediate collection), bankruptcy only incompletely honors the priorities of higher priority creditors, appearing instead to favor lower priority creditors and the debtor.¹⁸ Some commentators have suggested that, if this risk sharing is viewed as a form of insurance, it arguably can be reconciled with the creditors' bargain model.¹⁹ By contrast, commentators unsympathetic to the contractarian nature of the Baird and Jackson analysis view bankruptcy's alteration of the parties' prebankruptcy priorities as evidence that the creditors' bargain approach is misguided. In their view, bankruptcy should, and does, implement important societal values not reflected in the creditors' bargain framework.²⁰

The most recent contractarian scholarship takes a different tack and calls into question Baird and Jackson's central assumption that bankruptcy is necessary to solve a common pool or prisoners' dilemma problem.

18. While the absolute priority rule theoretically protects secured creditors' priorities, confirmation of a consensual reorganization plan is only possible if every class of claims and interests approves the plan. Bankruptcy Code § 1129(a)(8). Ensuring universal approval frequently requires that higher priority creditors agree to accept less than full payment. See, e.g., David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 484 (1992). Moreover, a secured creditor is not entitled to receive postpetition interest unless it is oversecured. *Id.*; Bankruptcy Code § 506(b).

19. Robert E. Scott, *Through Bankruptcy with the Creditors' Bargain Heuristic*, 53 U. CHI. L. REV. 690 (1986) (proposing a "common disaster" explanation of bankruptcy); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989). Jackson and Scott argue that if many debtors (and perhaps low priority creditors) are risk averse, debtors may be willing to pay marginally higher interest rates in return for the assurance that secured creditors will contribute to any reorganization effort. As with the original version of the creditors' bargain heuristic, bankruptcy can be seen as implementing an arrangement—here, risk sharing—that the parties themselves would have agreed to in the absence of insurmountable coordination costs. *Id.* at 167-69. As Jackson and Scott acknowledge, however, the risk sharing that occurs under the current Bankruptcy Code seems poorly tailored to any such insurance goal. *Id.* at 200-01; Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 BANKR. DEV. J. 319, 329-31 (1991). Moreover, the prospect of risk sharing may distort managers' incentives prior to bankruptcy. Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 473 (1992) [hereinafter Adler, *Risk Allocation*].

20. Warren, *supra* note 2; Donald R. Korobkin, *Value and Rationality in Bankruptcy Decisionmaking*, 33 WM. & MARY L. REV. 333 (1992); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717 (1991).

remedies¹¹ and imposes a collectivized debt collection regime in their stead. In bankruptcy, creditors must act (and are dealt with by the debtor) primarily in classes rather than as individuals.¹²

In the early 1980s, Thomas Jackson offered the first systematic attempt to normatively justify bankruptcy's alteration of the individual contracts entered into by a debtor and its creditors.¹³ Jackson and his frequent co-author, Douglas Baird, base their conception, the creditors' bargain model, on what they describe as a "hypothetical bargain" among creditors.¹⁴ Were creditors able to bargain among themselves *ex ante*, Baird and Jackson argue, they would agree to restrain from exercising their individual collection rights in the event the debtor encountered financial difficulties. Otherwise, a costly "race to the courthouse" would develop, with each creditor rushing to enforce its collection rights at the first sign of trouble, lest other creditors get there first and levy on all of the debtor's available assets. In their zeal to ensure satisfaction of their particular debts, the creditors might dismember a debtor that, on reflection, all would agree is worth more to the creditors collectively as a going concern.¹⁵

Baird and Jackson argue that creditors are too widely dispersed to bargain effectively among themselves; bankruptcy is therefore necessary to implement the bargain to which the parties would have agreed had negotiation been possible: in particular, to require that creditors restrain from prebankruptcy races to the courthouse.¹⁶ But bankruptcy should not alter the parties' state law entitlements in any other way. Both to prevent forum shopping and to give secured creditors sufficient incentives to participate, the substantive rules in place in bankruptcy should mirror those operative outside of bankruptcy.¹⁷

11. Bankruptcy Code § 362 imposes an automatic stay on most efforts to collect on a debt owed by the debtor.

12. See, e.g., Bankruptcy Code § 1123 (requiring proponent of a reorganization plan to designate classes of claims and interests).

13. See Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements and the Creditors' Bargain*, 91 YALE L.J. 857 (1982).

14. See, e.g., THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984).

15. Jackson, *supra* note 13, at 862.

16. Baird and Jackson describe creditors' predicament in terms of the familiar prisoners' dilemma and common pool puzzles developed by economists. The problem in each case is that even rational individuals may make collectively suboptimal decisions if they are unable to coordinate their choices. *Id.*

17. *Id.* at 867-70.

One branch of this criticism argues that the common pool characterization focuses only on creditors, whereas in reality the debtor plays a crucial role in the process.²¹ Another suggests that even if there were a risk that creditors would dismember a viable debtor, the parties themselves could prevent this result through the skillful use of secured credit arrangements.²² Much more than their predecessors, these critiques go to the very heart of the creditors' bargain model justification of bankruptcy.

B. The New Proposals to Replace Chapter 11

As discussed earlier, Michael Bradley and Michael Rosenzweig drew national attention early last year when they argued that Chapter 11 should be abolished. On a theoretical level, the recent commentary discussed above—in particular, the doubts it casts on the most important normative justification for bankruptcy—underlies their and other recent calls for an end to Chapter 11. But this in itself cannot explain the sudden public interest, and debate, as to the future of the current bankruptcy regime.²³ The intensity of the controversy stems from an increasingly widespread perception not only that Chapter 11 is unnecessary, but that it also may have affirmatively harmful consequences for many firms.

Two central concerns help explain why Chapter 11 is suddenly more out of fashion than Nero. The first, and most obvious, issue is the tremendous costs of Chapter 11. The attorneys' and accountants' fees alone can be substantial in a lengthy case, and Chapter 11 creates significant indirect costs, such as disruption and lost opportunities, as well.²⁴ It does not take too many Chapter 11s like the Eastern Airlines

21. James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097, 2111-13 (1990) [hereinafter Bowers, *Murphy's Law*]. See also James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27 (1991) [hereinafter Bowers, *Loss Distribution*].

22. Randal C. Picker, *Security Interests, Misbehavior and Common Pools*, 59 U. CHI. L. REV. 645 (1992).

23. For examples of recent articles about the Bradley & Rosenzweig proposal, see Emily Barker, *Pair Puts Spotlight on Chapter 11's Flaws*, AM. LAW., May 1992, at 119; Peter Passell, *Economic Scene: Fun, Games, Bankruptcy*, N.Y. TIMES, Apr. 29, 1992, at D2; Allen R. Myerson, *Rethinking the Law that Gives Golden Eggs After the Goose is Dead*, N.Y. TIMES, Apr. 5, 1992, at E2; Michelle Singletary, *Panel Votes to Form Bankruptcy Study Body*, WASH. POST, Mar. 20, 1992, at F1; Wade Lambert & Milo Geyelin, *Bankruptcy Lawyers Dispute Call for Scrapping Chapter 11 Process*, WALL ST. J., Mar. 19, 1992, at B5.

24. Estimates of the direct costs of bankruptcy range to as high as 25% of a debtor's asset value, see DAVID T. STANLEY & MARJORIE GIRTH, *BANKRUPTCY:*

fiasco to raise widespread questions as to whether these costs generate sufficient offsetting benefits. Second, Chapter 11 may also have negative effects even before a firm files for bankruptcy relief. Commentators have focused in particular on managers' incentives. Because it limits the downside of any business disaster, they reason, Chapter 11 encourages managers to issue excessive debt and otherwise take excessive risks.²⁵

What should be done if we conclude that Chapter 11 has failed of its essential purposes? Almost all of the recent literature argues for the adoption of one or more of four general alternatives in place of the current regime: 1) auctions; 2) implementation of a predetermined bankruptcy capital structure; 3) automatic cancellation of shareholders' interests; and 4) elimination of bankruptcy altogether. I devote the remainder of this part to a brief discussion of the various proposals and of the advantages they appear to offer over Chapter 11.

1. THE BANKRUPTCY AUCTION

In its current form, Chapter 11 combines the decisions as to how a firm's assets should be deployed—i.e., should the firm be liquidated or reorganized, and if reorganized, in what form—with those concerning the parties' claims and their priorities vis-a-vis one another. This intertwining of the asset deployment and claimant entitlement issues creates two significant and related costs. First, parties' views about entitlement may color their perceptions concerning asset deployment. For instance, unsecured creditors may support an inferior reorganization plan if it offers them a larger piece of the overall pie.²⁶ Second, inability to

PROBLEM, PROCESS, REFORM 263 (1971), but other commentators provide substantially lower estimates. See, e.g., Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285 (1990) (average of 3%). For discussions of the indirect costs of bankruptcy, see Adler, *Risk Allocation*, *supra* note 19, at 465-66; Robert H. Mnookin & Robert B. Wilson, *Rational Bargaining and Market Efficiency: Understanding Pennzoil v. Texaco*, 75 VA. L. REV. 295, 313 (1989).

25. Adler, *Risk Allocation*, *supra* note 19, at 473-74; Bradley & Rosenzweig, *supra* note 4, at 1047. Bradley and Rosenzweig attribute far greater evils to the managers of bankrupt firms, suggesting not only that their decision-making incentives are problematic, but that managers affirmatively divert assets away from the other constituencies of the firm. *Id.* at 1052, 1075. The problem with this assertion is that Bradley and Rosenzweig offer absolutely no evidence of how managers are able to perpetrate such a heist, and the observations of other scholars and practitioners contradict their management looting thesis. See, e.g., LoPucki, *supra* note 5, at 94-97. The frequency with which managers are displaced in Chapter 11 makes the thesis particularly suspect. *Id.* at 95 (high management turnover); Stuart C. Gilson, *Bankruptcy, Boards and Blockholders*, 27 J. FIN. ECON. 355 (1990) (same).

26. I discuss this problem in somewhat more detail in an earlier article. Skeel, *supra* note 18, at 502-03. See also Baird & Jackson, *supra* note 14, at 108.

resolve asset deployment issues until heterogeneous groups of claimants thrash out their entitlement disputes is costly and can all but paralyze a firm for the duration of a Chapter 11 case. Many observers point to this second concern, the need for negotiation among heterogeneous creditors, as Chapter 11's single greatest flaw.²⁷

Douglas Baird was perhaps the first to suggest that Chapter 11 might profitably be jettisoned in favor of an auction, at least if the debtor is a large, publicly held firm.²⁸ The chief virtue of a mandatory bankruptcy auction is that it would separate the deployment and entitlement decisions. Under such a regime, a court or a trustee would sell the bankrupt firm to the highest bidder, thus ideally moving the assets to their most valued use quickly and inexpensively. This would enable the court to determine priority and other issues separately, and simply give the claimants their share of an extant pot of cash. Replacing the hypothetical sale of Chapter 11 with an actual sale might therefore both improve the quality of the asset deployment decision and decrease the deadweight costs of bankruptcy.

2. IMPLEMENTATION OF A PREPLANNED CAPITAL STRUCTURE

Both Alan Schwartz and Robert Rasmussen have recently suggested that firms should be permitted to opt out of bankruptcy if they so choose.²⁹ If Chapter 11 were optional, rather than being a firm's only choice of insolvency regime, debtors might devise their own alternatives to bankruptcy; firms might, for instance, provide for a special "bankruptcy capital structure" in their debt contracts or their charter,

27. See, e.g., Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 538-40 (1983) [hereinafter Roe, *A New Model*]; Philippe Aghion, Oliver Hart, & John Moore, *The Economics of Bankruptcy Reform*, at 8-9 (1992) (unpublished manuscript). One way to address this problem is to narrow the range of potential bargaining, so as to minimize the likelihood of strategic behavior by the parties. Several of the rules I propose in Part IV would have precisely this effect.

28. Baird, *Corporate Reorganizations*, *supra* note 2, at 139-41; Adler, *Risk Allocation*, *supra* note 19, at 488. Mark Roe had previously proposed a partial auction approach, suggesting that courts might sell a portion of the stock of a Chapter 11 debtor to the market as a means of determining the value of the firm, Roe, *A New Model*, *supra* note 27. Several years after the Roe and Baird articles, Lucian Bebchuk offered an options-based approach to the reorganization process. Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 785-88 (1988). I discuss the Bebchuk proposal (as incorporated into another recent auction proposal) at greater length *infra* Section II.A.2.

29. Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J.L. & ECON. (forthcoming 1993); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992).

consisting of preplanned adjustments that would be triggered by financial distress.³⁰ Rasmussen suggests that even firms opting for Chapter 11 in its current form could take advantage of this flexibility. A firm wishing to make use of the new value exception to the absolute priority rule, for instance, could specify in advance how much equity holders must contribute and what portion of the firm's stock they would receive in return.³¹

Use of a predetermined capital structure would ideally simplify *both* the asset deployment and the claimant entitlement decisions, since the parties would make these decisions in advance, at a time when their interests are more likely to be congruent. The strategy also seems largely to obviate the need for judicial involvement in the insolvency process.

3. AUTOMATIC CANCELLATION OF SHAREHOLDERS' INTERESTS: THE CONTINGENT/CHAMELEON EQUITY PROPOSAL

The Bradley and Rosenzweig proposal, which has been modified and refined by Barry Adler as a "chameleon equity" approach³² (I will refer to the proposals together as "contingent/chameleon equity"), boasts similar virtues. These commentators argue for automatic cancellation of shareholders' interests in the event of a default. Upon cancellation of shareholders' interests, the next highest class of claimants would replace them as the firm's shareholders.³³

Bradley and Rosenzweig envision that a firm in danger of defaulting on its obligations will raise money by issuing equity. Only when the firm's liabilities exceed its assets, and its stock has therefore become worthless, will the firm be unable to sell equity. The firm's subsequent default will reflect true insolvency, thus justifying the elimination of its current stockholders' interests.³⁴

30. Neither Schwartz nor Rasmussen suggests that firms should be required to devise a firm-specific insolvency capital structure. Rather, Schwartz attempts to demonstrate that firms could plausibly replicate the virtues of bankruptcy through contract; Rasmussen argues for a menu of possible insolvency regimes which would give firms, as one of their options, the right to develop their own tailor-made insolvency regime.

31. Rasmussen, *supra* note 29, at 110-11.

32. Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993) [hereinafter Adler, *Financial and Political Theories*]. Adler's article, which was written contemporaneously with Bradley and Rosenzweig's, cures many of the more prominent defects of the contingent equity proposal. See, e.g., *infra* note 87.

33. Adler, *Financial and Political Theories*, *supra* note 32; Bradley & Rosenzweig, *supra* note 4, at 1078-86.

34. Bradley & Rosenzweig, *supra* note 4, at 1081-82.

One potential benefit of automatic cancellation is its effect on managers' incentives. Because managers cannot look forward to the "soft landing" provided by Chapter 11 in its current form, they will be less inclined to gamble excessively with the firm's assets. Like the implementation of a predetermined capital structure alternative discussed above, automatic cancellation also dramatically simplifies the asset deployment and claimant entitlement questions by resolving them in advance, and all but eliminates the role of the court.

4. ELIMINATION OF CHAPTER 11 ALTOGETHER

Some commentators have at least tentatively suggested that Chapter 11 should be eliminated altogether and that creditors and their debtors should simply be left to the state law collection regime.³⁵ James Bowers frames such a suggestion as a critique of the common pool metaphor underlying Baird and Jackson's creditors' bargain model.³⁶ As discussed earlier, Bowers argues that this metaphor ignores the role of the debtor as the most efficient liquidator of its estate. In his view, bankruptcy's "equal treatment of similarly situated creditors" norm, and its prohibition of preferences, may interfere with debtors' efforts efficiently to distinguish among their creditors in responding to financial crises.³⁷ Thus, abolishing Chapter 11 not only would save the direct and indirect costs of a bankruptcy proceeding, it might also facilitate more efficient adjustments by debtors in the event that disaster strikes.

II. WHAT A WONDERFUL WORLD IT WOULD BE?

In this part, I take a closer and more critical look at each of the proposals described in Part I. My aim throughout is to present a fuller picture of the consequences the proposals would have and implicitly to ask, with respect to each, whether it offers an improvement over current Chapter 11. In subsequent parts, I will consider whether Congress is

35. Bowers, *Murphy's Law*, *supra* note 21; Bowers, *Loss Distribution*, *supra* note 21. Bowers's approach differs from Robert Rasmussen's "menu approach" to bankruptcy, Rasmussen, *supra* note 29, in that whereas Bowers appears at times to assume that debtors would forgo bankruptcy altogether were it abolished, Rasmussen suggests that firms would devise their own alternatives. To facilitate this process, Rasmussen argues that Congress should give the parties several preformulated options, including the current Chapter 7 and Chapter 11 regimes, as well as permitting them to create their own alternative.

36. Bowers, *Murphy's Law*, *supra* note 21, at 2108-13.

37. *Id.*; Bowers, *Loss Distribution*, *supra* note 21, at 33-35.

likely to adopt any of the proposals, and I will suggest an alternative blueprint for change.

A. Chinks in the Case for Mandatory Auctions

1. A WORLD THAT ONLY ALLOWED AUCTIONS

Mandatory auctions intuitively seem to offer tremendous savings in comparison with the cost of a protracted Chapter 11 case. An auction can move the assets of a financially troubled firm to the highest valuing user much more quickly, and can prevent asset deployment decisions from bogging down in the parties' negotiations over their respective entitlements. But on closer inspection the promise of mandatory auctions is far less clear.

The chief problem with the mandatory auction proposal—one which largely renders moot the question whether auctions would be any less costly than Chapter 11³⁸—is that it simply would not work as intended in the insolvency context. First, auctions are likely to be plagued by an absence of potential bidders. At least with respect to publicly held debtors, few bidders could raise financing sufficiently quickly to participate actively in an auction market.³⁹ While the existence of an auction market might itself generate increased interest in the financial community, the likelihood of a truly competitive market seems remote. This dilemma is exacerbated by the fact that the most likely bidders for a corporation frequently are firms in the same industry. If the problems that led to the debtor's demise were industry-wide, few or none of these firms would be able to bid.⁴⁰ Even more than with the corporate

38. The direct costs of an auction regime would include not only the costs (such as advertising, hiring an investment banker, and providing information to potential bidders) of conducting the auction, but also the cost of resolving the parties' respective entitlements, since auctions would not eliminate this aspect of bankruptcy. See, e.g., DOUGLAS G. BAIRD, REVISITING AUCTIONS IN CHAPTER 11 (Chicago Law and Economics Working Paper No. 7 (2d Series) 1992). Similarly, while auctions appear to minimize the indirect costs of bankruptcy, they might simply shift these costs forward in time. Whereas firms' attention currently is diverted, and opportunities are lost, during bankruptcy, the prospect of an auction might cause managers to devote all of their energy to forestalling bankruptcy in the event of financial difficulties, thus distracting the firm prior to bankruptcy. *Id.* In short, a comparison of the costs of auctions, to those of the current regime, proves inconclusive at best.

39. Roe, *supra* note 27, at 573; Aghion et al., *supra* note 27, at 8.

40. See Andrei Shliefer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 1343 (1992).

takeover market, a very small number of players would dominate the auction process in bankruptcy.⁴¹

Second, even in an otherwise competitive market, the potentially enormous costs of gathering and analyzing information, of choosing an appropriate capital structure for the firm, and of the bidding process itself would deter many bidders. Each bidder knows that these costs will be lost for all except the winning bidder and that, if the auction is hotly contested, every bidder may end up with losses. As a result, many bidders will decide (perhaps after a brief exploratory effort) not to make a serious effort to investigate the firm and to enter the bidding process.⁴² The chilling effect of bidding costs further calls into question the likelihood of an effective auction process.⁴³

Robert Gertner and Randal Picker have recently pointed out an additional problem with mandatory auctions in bankruptcy. The financial

41. See, e.g., Edward B. Rock, *Antitrust and the Market for Corporate Control*, 77 CALIF. L. REV. 1365, 1379 (1989) (market for corporate control is more similar to market for art than to a thick competitive market due the relative dearth of prospective buyers for any given company at a particular time). A recent empirical study by LoPucki and Whitford reinforces the concern as to the number of likely bidders. LoPucki and Whitford found that, in the auctions currently taking place in Chapter 11, there frequently is only one bidder. See Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 764-65 (1993).

42. See, e.g., Aghion et al., *supra* note 27, at 10. The dilemma outlined in the text is somewhat analogous to the "first mover" problem. The first mover problem stems from bidders' perception that, once one bidder has incurred the costs of investigating a firm and preparing a bid, that bidder will bid up to the full value of the firm in the event of a competitive auction. Subsequent bidders may thus face a "lose-lose" situation: If they bid the value of the firm or less, they will lose the bidding; and if they bid enough to win, they will have overpaid. As a result, subsequent bidders will refrain from bidding, and the first bidder will win with a low bid. See, e.g., Adler, *Financial and Political Theories*, *supra* note 32, at 321. There is reason to doubt that the first bidder will get a completely accurate picture of the firm's value even after investigation (especially if management is uncooperative); moreover, the first mover problem is likely to arise only in the "common values" context, that is, where the assets have the same value for all potential bidders. Further, the problem could be minimized in bankruptcy by giving multiple bidders equal access to the firm, and requiring that bids be submitted simultaneously. Nevertheless, the ultimate effect in bankruptcy is likely to be the same: Few bidders will come forward in any given auction.

43. Note that, even if bidders ignored the risks discussed in the text, and did in fact bid competitively, an auction regime still would be problematic. Rather than paying too little for a debtor corporation, the winning bidder might frequently pay too much. See, e.g., Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597 (1989) (discussing the "winner's curse" problem in the takeover context); ERIC RASMUSSEN, *GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY* 252 (1989). This might force winners to cannibalize the company, and would significantly increase the likelihood of a subsequent return to bankruptcy.

statements of a firm experiencing financial distress give a misleading picture of the firm, due to the fact that managers frequently take unusual actions in an effort to forestall bankruptcy—managers will have preferred some creditors and left others unpaid, for instance, and otherwise juggled their cash flow.⁴⁴ In contrast to bankruptcy, which creates a “breathing space” during which creditors and third parties can observe the debtor under somewhat more normal conditions, a mandatory auction would require bidders to make their bids almost immediately. The atypical nature of the firm’s activities in the period before the auction would further distort the bidding process; it might also force the winning bidder to postpone or forego potential opportunities until she has time to observe the firm in operation.

Because small and medium-sized firms tend to be local or regional in scope, do not regularly supply financial information to the markets, and are most effective if their owners also manage the firm, the limitations of an auction regime would be exacerbated in this context. Moreover, bidders’ realizations that the success of a close corporation usually depends upon the continued involvement of its current managers, and that the managers would refuse to stay on board unless they retained their ownership interest, would significantly dampen their incentive to bid. In short, mandatory auctions are problematic even for publicly held corporations and seem wholly implausible as an alternative to Chapter 11 for smaller corporations.

2. AGHION, HART, AND MOORE: THE OPTIONS ALTERNATIVE

Aghion, Hart, and Moore have recently proposed a modified version of the mandatory auction proposal, one which uses an options scheme originally proposed by Lucian Bebchuk, in an effort to remedy several defects of a pure auction regime.⁴⁵ In an options regime, the bankruptcy judge or other official would begin by determining the amounts and respective priorities of all of the claims and interests in the financially troubled firm. The court would distribute all of the firm’s stock (subject to redemption) to its senior creditors in lieu of their claims, and members of each lower class would be given options to purchase a pro rata share of the stock temporarily held by senior creditors. A second priority creditor could exercise her option to purchase stock by paying her pro rata portion of the senior debt; a third priority creditor could do so by paying her pro rata portion of the senior debt plus her pro rata share of

44. Robert Gertner & Randal C. Picker, *Bankruptcy and the Allocation of Control* (1992) (unpublished manuscript).

45. Aghion et al., *supra* note 27.

the second priority debt; and so on.⁴⁶ The proposal contemplates that lower priority creditors and shareholders would exercise their options only if they felt the firm was worth more than the sum of all superior claims. Thus, the process would ideally put stock in the hands of the true residual claimants of the firm, and provide for payment in full of the firm's higher priority creditors.

In addition to overseeing the options process, the judge simultaneously would take bids for the firm. Both insiders, such as the firm's managers, and third parties could bid, and bids need not be in cash or contemplate payment to the new shareholders to qualify.⁴⁷ Thus, the current managers could offer to continue running the company and propose that the new shareholders simply retain their stock, just as a third party could offer to buy the firm from its shareholders in cash. Once the bids were in, the shareholders would vote for whichever proposal they found most attractive. In the view of Aghion, Hart, and Moore, the entire process could be completed in three or four months.⁴⁸

The principal advantage of the options alternative lies in its opening up of the bidding process. By allowing both cash and noncash bids, the options approach reduces the likelihood that only one bidder will bid, since entry would not be limited to bidders capable of financing an outright sale. It also reintroduces the possibility that the firm could reorganize under current management without the intervention of a sale, thus retaining the chief benefit of Chapter 11, yet without sacrificing the disciplining effect that the prospect of an auction has on managers' behavior prior to bankruptcy: Only if management could persuade the new shareholders to support such a plan, in preference to all of the other bids, would it win out.

The most obvious problem with the options approach, as with the Bebchuk proposal upon which it is based, is that the distribution and exercise of options that the scheme envisions would only work effectively in a perfectly efficient market.⁴⁹ Even if claimants could accurately predict the value of the firm (an extremely problematic assumption,

46. *Id.* at 16-18; Bebchuk, *supra* note 28.

47. Aghion et al., *supra* note 27, at 14-15.

48. *Id.* at 14, 17-18.

49. Aghion, Hart, and Moore anticipate this problem with their proposal, and suggest four alternative means of allocating equity. Unfortunately, the alternatives are, if anything, more problematic than the option scheme. *Id.* at 24-25. Two of the alternatives—allocating equity in proportion to the face value of the claims against a firm, and simply allocating all equity to secured creditors—are arbitrary and would create huge strategic behavior problems. The third and fourth, basing the allocation on the highest cash bid received or on the valuation of an outside investment bank, are only marginally more likely to yield an appropriate allocation.

particularly in the insolvency context) and, based on their prediction, make informed decisions as to whether to exercise, the proposal forces them to contribute new cash to the firm if they wish to receive stock. Many claimants may have difficulty raising the necessary cash;⁵⁰ one suspects, especially in the small firm context, that these claimants would simply let their options lapse if they have any doubts about the value of their claim.⁵¹

Moreover, a court could not begin distributing stock options to the parties until *after* it had resolved the parties' entitlement disputes; nor could it open the bidding process prior to this point (despite the proposal's suggestion to the contrary), since shareholder and creditor bidders could not bid until they knew their status within the firm. Untangling the parties' entitlements would significantly delay the auction, often to a date well beyond the four months the proposal predicts for the entire process.

Finally, although the options approach does expand the bidding process, its auctions still would suffer from a serious lack of outside bidders, since industry-wide financial difficulties would create the same problems in this context as they would for the traditional auction approach. In addition, other potential bidders might decline to participate for fear that, because the firm's managers also are likely to be bidders, the managers may and probably would stonewall outsiders who sought to acquire detailed information about the firm.

In short, the options approach offers a valuable twist on the mandatory auction regime, but it is far from a perfect solution to the ills of Chapter 11.

B. A Closer Look at Preplanned Adjustments to the Capital Structure

Preplanned adjustments represent an important departure from the auction-based proposals discussed in the previous section. By deciding its response to financial crisis in advance, the firm eliminates almost all of the direct costs of bankruptcy. Such a regime obviates both the need for an ex post judicial (as in current Chapter 11) or market (as with an

50. The problem is one of transaction costs, and is analogous to the familiar observation in contract law that transaction costs may preclude parties from bargaining around an inappropriate default rule. See, e.g., Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 109-11 (1989).

51. Aghion, Hart, and Moore suggest that the problem could be alleviated by the development of a market for the parties' options, but the likelihood of a competitive options market seems negligible for small and medium sized firms, and problematic even with respect to publicly held debtors.

auction) valuation, and the need for costly ex post bargaining among the parties. In effect, we shift with this proposal⁵² from a partially market-based alternative, to an entirely market-based one.

Two related defects raise serious questions about the proposal, however. First, the costs of negotiating a capital structure in advance could outweigh, and at the least would reduce, the ex post benefits.⁵³ A debtor would incur these costs even if shifting to the special capital structure never became necessary.⁵⁴ Only if insolvency were relatively likely, or the costs of negotiation low, would preplanned adjustments seem a promising solution to the inefficiencies of current Chapter 11. Even if these conditions were present, the firm would need to consider whether suppliers and other third parties might be hesitant to do business with a firm that has already crafted a tailor-made framework for dealing with its own insolvency.

Second, choosing an insolvency capital structure in advance requires the parties to predict the future. If the firm guessed wrong about the likely source of financial difficulties, changed significantly between its inception and the time it encountered trouble, or both, the special insolvency structure could prove wholly ineffective. To be sure, the parties could attempt to adjust their prearranged structure midstream in an effort to address changed conditions, but negotiations of this sort would be costly and frequently unsuccessful.⁵⁵ In short, the initial negotiating costs and the possibility that midstream adjustments might become necessary would significantly limit the usefulness of preplanned adjustments for many, and perhaps almost all, firms.

52. As noted earlier, neither Rasmussen nor Schwartz argues that debtors should be required to adopt a firm-specific capital structure. Rather, they suggest that some debtors might do so if given the opportunity.

53. Even if a debtor were to adopt a preplanned adjustment strategy unilaterally, she still would incur both the costs of devising an appropriate framework, and the costs of persuading current and future creditors to agree to the plan.

54. Adler, *Financial and Political Theories*, *supra* note 32, at 322.

55. See Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981). Rasmussen's response to the possibility of midstream changes by a debtor in its choice from a "menu" of possible insolvency regimes is hampered by closely analogous problems and therefore is not a solution to the dilemma. Rasmussen, *supra* note 29, at 117-18. Rasmussen argues that unanimous creditor consent should be required as a prerequisite to any menu selection change that could be the result of strategic behavior by the debtor. Alteration of a tailor-made insolvency structure would inevitably fit this definition. Thus, the holdout and negotiation costs discussed in the text would always come into play.

C. Another Look at Contingent/Chameleon Equity

The contingent/chameleon equity proposal proffered by Bradley and Rosenzweig, and by Adler, can be seen as an off-the-rack version of prearranged capital structure. Simply committing to cancel current equity in the event of default, as these commentators propose, saves the parties the costs of negotiating a firm-specific insolvency capital structure and appears to address the twin goals of disciplining management and avoiding the expense of a prolonged bankruptcy proceeding.⁵⁶ The proposal also would introduce significant costs, however. Given the particular prominence of this proposal, I discuss the costs in some detail below.

1. THE LIQUIDITY PROBLEM

Initial criticism has focused upon Bradley and Rosenzweig's suggestion that the cancellation of equity would rarely be triggered by premature defaults, as one might fear. So long as the firm is solvent, its managers could solve any cash flow problems by issuing additional equity. Critics have pointed out that this proposal, like the options alternative discussed above, assumes that markets function with perfect efficiency: Managers must be able to raise money quickly and cheaply, in an equity market that assesses accurately the value of the firm.⁵⁷

In the context of publicly held firms, it is at least remotely possible that the market would function somewhat as Bradley and Rosenzweig imagine. To assess the cost of a contingent/chameleon equity regime, one would need to consider the very significant costs of raising equity.⁵⁸ One must also take into account the lagtime between the decision to issue equity and actual receipt of the funds. Only if firms could predict a cash crunch sufficiently far in advance, would the equity solution prove effective.⁵⁹ A final concern is the risk that cash-strapped firms might be forced to sell equity at artificially low, "fire sale" prices.⁶⁰ Inability to

56. See *supra* notes 32-34 and accompanying text.

57. See, e.g., LoPucki, *supra* note 5, at 99-101.

58. See, e.g., HARRY G. HENN & JOHN R. ALEXANDER, *LAWS OF CORPORATIONS* 786-91 (3d ed. 1983) (describing the costs and procedures of a public issuance of securities).

59. The time problem is likely to be particularly acute if the issuance is a public offering and requires compliance with the strictures of the Securities Act of 1933. *Id.*

60. Firms generally try to time their issuance of equity to favorable market conditions, which need not necessarily be directly correlated with the underlying value of the corporation in question, so as to maximize the price they receive. See, e.g., Udayan Gupta & Brent Bowers, *IPO Slump Is Stalling Expansion of Small Businesses*, WALL ST. J., July 2, 1992, at B2 (describing firms' decisions to hold off or scale back on planned

wait even so much as a week or month could prove particularly costly for a firm. On the other hand, many large firms *do* look to the equity markets for help with their cash flow problems. General Motors, for example, issued equity several times in recent years in response to balance sheet problems that had made other forms of financing unattractive. To the extent it might force managers to be more judicious in their use of debt, and to the extent the option of issuing equity is available to address temporary crises, contingent/chameleon equity has some initial appeal for a publicly held firm.

Closely held and other small and medium-sized firms are an entirely different story. Issuance of equity is not a viable response to financial difficulties for many of these firms, since the transaction costs alone of a new public issue are likely to be prohibitive.⁶¹ Moreover, investors may hesitate to acquire a minority interest in a close corporation, and dilution of control would undermine many of the virtues of a closely held firm.⁶² Downsizing, or sales of nonessential assets, would be equally unavailable as alternatives for firms whose value is tied up in crucial equipment. In short, the liquidity problem alone raises serious doubts about contingent/chameleon equity for all but a narrow slice of publicly held firms. The proposal also suffers from additional defects with respect to both these and smaller firms.

2. STRATEGIC BEHAVIOR IN PUBLICLY HELD CORPORATIONS

A recurring problem with forfeiture rules—rules that eliminate one party's interest if a specified triggering event occurs—is that they create enormous incentives for strategic behavior. The treatment of express conditions in contract law is a particularly good example of this phenomenon. Because contract law excuses one party to a contract from performing if the other fails to satisfy a condition, regardless of how trivial the defect in performance, a nonbreaching party can use the failure strategically, as a means of escaping a contract the nonbreaching party has come to regret.⁶³

offerings rather than sell equity at fire sale prices). A firm faced with immediate equity cancellation obviously would be forced to accept whatever price the market would pay.

61. See Robert E. Scott, *A Relational Theory of Secured Transactions*, 86 COLUM. L. REV. 901, 915-16 (1986) [hereinafter Scott, *A Relational Theory*].

62. *Id.* at 914-15 (describing a debtor's incentive to shirk or engage in self-dealing if her ownership share is diminished).

63. The case of *Internatio-Rotterdam, Inc. v. River Brand Rice Mills, Inc.*, 259 F.2d 137 (2d Cir. 1958), is illustrative. In *Internatio-Rotterdam*, a forward contract required the seller to deliver 95,600 pockets of rice to the buyer the following December, at a contract price of \$8.25 per pocket. Delivery was conditioned on seller's receipt of

Both Bradley and Rosenzweig, and Adler neglect this problem; yet, in publicly held firms, contingent equity would create a serious risk of similar opportunism. First, like a nonbreaching party in the express condition context, the unsecured creditors of a publicly held firm could use the equity cancellation rule to divert value from shareholders to themselves. To appreciate how this might work, consider a corporation that owes \$7,000,000 to senior creditors and \$2,000,000 to junior unsecured creditors, and whose total value is roughly \$10,000,000. Unsecured creditors would have a tremendous incentive to call for equity cancellation if management violated a technical default provision, because doing so would give them 100% of the equity of a firm that now had a net value of \$3,000,000.⁶⁴ In fact, the bondholders' trustee might even be liable for breach of fiduciary duty if she *failed* to take advantage of this opportunity: In particular, if the firm later experienced serious financial difficulties, bondholders might contend that the trustee should have taken action earlier, when bondholder values could have been salvaged.

The parties might attempt to curb the threat of strategic behavior by adjusting the default provisions in their debt contracts. One might expect to see fewer "early warning signal" default provisions, and a greater reliance on default provisions (such as payment terms and prohibitions on the sale of essential assets) likely to be triggered only in the event of true, nontemporary financial reverses, as well as more widespread use of cure provisions. Unfortunately, while restricting the breadth of debt contract default terms in this fashion might reduce strategic behavior somewhat,

shipping instructions from buyer two weeks in advance. *Id.* at 139. By December, the market price had risen to \$9.75 per pocket. When the buyer neglected to provide the instructions sufficiently early both to give the seller two weeks notice and to allow for delivery before the end of December, the seller immediately rescinded the contract. *Id.* The court found for the seller, holding that the buyer's failure to strictly comply with the conditions of delivery released the seller from its obligations. *Id.* at 140.

Not surprisingly, courts have mitigated the harshness of the strict compliance rule in some cases by invoking exceptions such as the substantial performance rule, *see, e.g.*, *Jacob & Youngs v. Kent*, 129 N.E. 889 (N.Y. 1921), or by finding that the nonbreaching party waived the condition. *See Universal Builders, Inc. v. Moon Motor Lodge, Inc.*, 244 A.2d 10 (Pa. 1968). One suspects that, to the extent the parties did not limit the contingent/chameleon equity default term or provide for a cure period, as discussed below, courts would develop similar exceptions so as to alleviate the regime's more problematic consequences.

64. Thus, the effect of equity cancellation is to increase the value of the unsecured creditors' interest from \$2 million to \$3 million. Unsecured creditors' strategic incentives might seem to be reduced if they are significant players in both the equity and the debt markets, since equity cancellation would, in a sense, be robbing Peter to pay Paul. But there will always be players in a given firm whose interests are only in debt (and dual players might still be tempted if, with respect to the firm in question, they only own debt).

it also would seriously increase the indirect costs of financial difficulties.⁶⁵ Faced with the prospect of equity cancellation, managers would attempt to forestall the day of reckoning by juggling balance sheets and foregoing current opportunities; unsecured creditors would be largely unable to nip these stalling tactics in the bud.⁶⁶

The second strategic behavior problem arises from the uncertainty as to who will manage the firm in the event of an equity cancellation. Adler suggests that the firm's new shareholders, its current unsecured creditors, should vote on the managers.⁶⁷ The vote he envisions would entail significant expense, including both the direct costs of holding an election and the indirect costs of forgone opportunities during the time before a management team is firmly in place.⁶⁸ The prospect of these costs, together with the prospect of substantial indirect costs prior to default, would give unsecured creditors an incentive to strike a deal with the firm's current managers. The unsecured creditors might offer a side payment, or agree to keep the current managers in place after the equity cancellation, in return for the managers' agreement not to make extraordinary efforts to forestall default.⁶⁹

In short, in a contingent/chameleon equity regime, unsecured creditors could divert value from shareholders to themselves by either strategically invoking default provisions in their debt contract or colluding with management, or both.

65. The analysis in the text therefore suggests that, as with an auction regime, contingent/chameleon equity would not eliminate, and might not even reduce, the indirect costs of insolvency. Instead, it would simply shift these costs forward in time, so that costs occurred before rather than during bankruptcy.

66. Moreover, neither narrower defaults nor even provisions giving the debtor a cure period would fully eliminate the risk of strategic behavior. Whereas bankruptcy currently acts as a credible threat for debtors, and restrains creditors from declaring default opportunistically, unsecured creditors in a contingent/chameleon equity regime would have an incentive to enforce strictly any cure provision.

67. Adler, *Financial and Political Theories*, *supra* note 32, at 324.

68. Another major problem with the management decision is the question of who will act as the unsecured creditors' agent in connection with the vote. Outside of bankruptcy, current management performs this function, as for example by nominating a slate of directors and recommending them to shareholders. Current managers obviously would be a poor choice of agents for the unsecured creditors in the wake of an equity cancellation. Unlike current Chapter 11, which employs committee representation as a means of addressing the parties' coordination costs, Bankruptcy Code § 1103, the contingent/chameleon equity proposal leaves this issue completely up in the air.

69. While managers who took such a side payment would be subject to suit for breach of their duty of loyalty if they somehow were caught, it is not clear that the ousted shareholders would have any direct recourse against the firm's unsecured creditors. In other words, the threat of a fiduciary duty suit is likely to be a poor deterrent.

3. MONITORING GONE AMOK: THE COST OF CREDIT IN CLOSELY HELD CONTINGENT/CHAMELEON FIRMS

As discussed above, the liquidity problem alone makes contingent/chameleon equity almost completely implausible for firms that are not publicly held. Liquidity is not the only problem in this context, however. The proposal would also undermine the use of secured credit and, as a result, significantly increase monitoring and thus overall credit costs. To appreciate the extent of the problem, it is necessary first to briefly describe the role of secured and unsecured credit.

a. Monitoring and the choice of capital structure

While the role of debt as a mechanism for disciplining managers and thus diminishing their conflicts of interest is well understood,⁷⁰ firms' use of different kinds of debt—particularly the choice between secured and unsecured credit—has proven to be an enduring puzzle. The most persuasive explanations for secured credit emphasize the bonding effect of security and the monitoring role that secured creditors perform, arguing that secured credit offers efficiencies in policing the debtor that reduce the overall cost of credit.⁷¹ The theories are limited, however,

70. Because it imposes fixed obligations on a firm and thus limits excess cash, debt gives managers a narrower margin of error. The effect is to increase the likelihood that incompetence will be exposed, and also to reduce managers' ability to engage in self-dealing. See, e.g., Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, AM. ECON. REV., May 1986, at 323. On the other hand, because excessive debt may cause managers to take too many risks, and introduces the threat of bankruptcy, firms also tend to include a significant amount of equity in their capital structures. See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

71. See, e.g., Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982) (correcting Jackson and Kronman's counterintuitive assumption that unsecured creditors are the best monitors); Scott, *A Relational Theory*, *supra* note 61. Other important, nonmonitoring efforts to explain secured financing include Frank Buckley's contention that security reduces screening costs, Francis H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986), and James White's hypothesis that security addresses problems of differential risk aversion. James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984). See also Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979); James H. Scott, *Bankruptcy, Secured Debt, and Optimal Capital Structure*, 32 J. FIN. 1 (1977). Alan Schwartz has authored several important articles pointing out the limitations of the various theories. Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984); Alan Schwartz, *Security Interests and Bankruptcy*

by their failure to explore the precise nature and full range of monitoring efforts.⁷²

By developing a simple typology of monitoring, one which draws from Adler's insights as well as those of other scholars, we can greatly enhance the explanatory power of current theories. Creditors monitor in either or both of two ways: First, they investigate the debtor before extending credit; second, some continue to monitor even after the loan documents are signed.⁷³ Creditors that engage in both preloan and midstream monitoring can be described as active monitors. Those that only investigate initially (and simply watch for payment defaults thereafter) are passive monitors.⁷⁴

Active monitoring—which may consist of policing assets, maintaining frequent contact, and even participating in the debtor's decision making processes—generally is far more expensive than passive monitoring. One would therefore expect to see more active monitoring in contexts where the debtor's conflicts of interest are particularly high: when the firm has a high debt/equity ratio, for instance, or when there is significant variability in the risk of the debtor's investment opportunities.⁷⁵ The existence of one or more active monitors does not mean that other creditors do not monitor at all; rather, they may monitor passively.⁷⁶

Priorities: A Review of Current Theories, 10 J. LEGAL STUD. 1 (1981). Schwartz recently has argued that Article 9's current treatment of secured credit should be largely abolished and replaced with a more true first-in-time regime. Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209 (1989).

72. See BARRY E. ADLER, A NEW PERSPECTIVE ON THE BANKRUPTCY PRIORITY PUZZLE, (Emory University Law and Economics Working Paper No. 31, 1991) [hereinafter Adler, *A New Perspective*].

73. Adler points out the distinction in a new article, focusing in particular on the importance to dispersed equity holders of the pre-loan investigation done by unsecured creditors. Adler makes the important point that unfavorable changes in the terms insisted upon by unsecured creditors will act as a signal to shareholders, warning them of potential problems. *Id.* at 22-23.

74. The terms "active" and "passive" are taken from Levmore. Levmore, *supra* note 71, at 74-75.

75. See, e.g., Francis H. Buckley, *The Termination Decision*, at 21-24 (1992) (unpublished manuscript). Buckley argues that termination, whether it be through foreclosure, bankruptcy, or some other means, should occur when equity's adverse incentives exceed those of creditors, and that the optimal termination point is affected by factors such as the debt/equity ratio and variability of risk.

76. Thus, suppliers of a close corporation will frequently consult the Dun & Bradstreet report on a particular firm prior to extending credit and, if problems develop, during the course of the parties' relationship. Similarly, the bond trustee representing widely scattered bondholders of a publicly held firm will review the firm's public filings for evidence of trouble. The use of Dun & Bradstreet and the appointment of a bond trustee can be seen as mechanisms for overcoming the collective action problems of dispersed creditors.

Secured credit can be seen as a mechanism for minimizing the expense of active monitoring.⁷⁷ First, the bonding aspects of secured credit—debtors' agreement to give a priority interest and to furnish ongoing documentation concerning the collateral—both deter misbehavior in the first instance and streamline the monitoring process.⁷⁸ Security also eliminates duplication of effort and the flipside problem of undermonitoring.⁷⁹ Secured credit achieves this efficiency by paying the best monitor, through its promise of priority, to do the active monitoring;⁸⁰ other creditors may then take advantage of the fruits of the secured creditor's efforts.⁸¹

This analysis helps explain the frequent absence of secured credit in publicly held corporations. Active monitoring may be unnecessary if the firm's debt/equity ratio is sufficiently low.⁸² Moreover, the frequent issuance and rollover of debt has a readily observable signalling effect

77. Scott has given the most extensive account of active monitoring in connection with his relational theory of secured financing. Scott, *A Relational Theory*, *supra* note 61, at 946-50.

78. Rather than visiting the debtor's business on a monthly basis, a bank may be able to review monthly leases or accounts receivable forwarded by the debtor, as well as changes in the debtor's bank account. Banks' ability to insist that the debtor maintain an account with them is one reason they are likely to be such good monitors. The bank account is relatively easy to monitor and also serves as a bonding device, because it gives the bank a source of setoff in the event the debtor fails to repay.

79. Levmore, *supra* note 71, at 55-57. It is interesting to note that secured lending in the publicly held firm context is often done by a syndicate of banks, rather than by a single bank. The presence of multiple banks enables each to limit its exposure, and does not create insuperable collective action problems because the group ordinarily is small enough to permit coordination of efforts. See MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (2d ed. 1971); RUSSELL HARDIN, *COLLECTIVE ACTION* (1982).

80. One difficulty with monitoring explanations of secured credit is that, because it reduces a creditor's risk, security seems to *decrease* the incentive to monitor. See Buckley, *The Bankruptcy Priority Puzzle*, *supra* note 71, at 1440. However, secured creditors still have substantial (even if not perfect) incentives to monitor if their collateral does not significantly exceed the amount of the loan. In addition, many secured creditors have an interest not only in the present loan, but also in the possibility of future transactions if the debtor is successful. See *infra* notes 84, 85.

81. One question that arises is, how do unsecured creditors benefit from secured creditor monitoring? Most importantly, other creditors benefit from the pressure secured creditor monitoring puts on a debtor to fully perform, rather than to shirk or otherwise fail to maximize the value of the corporation.

82. By contrast, we might expect to see an increase in secured credit with firms with investment opportunities whose risks are particularly variable or suddenly change for the worse. Note, however, that there also are other reasons for securing, such as secured creditors' superior treatment in bankruptcy (including the possibility of receiving pendency interest under Bankruptcy Code § 506(b)).

that further reduces the need for additional monitoring.⁸³ By contrast, closely held firms almost always have significant debt and a relatively small equity interest, thus necessitating a particularly active monitor.⁸⁴ Armed with the stranglehold of Article 9's priority rules, the debtor's secured creditor fills this role.⁸⁵

b. The cost of the contingent/chameleon

The problem with contingent/chameleon equity in this context is that it would impair a secured creditor's ability to actively monitor closely held debtors in the fashion described above. Because default has such draconian consequences in a contingent/chameleon equity regime, and because they are unlikely to find alternative financing if they encounter even temporary financial problems, closely held debtors would be even more concerned with narrowing the scope of default terms, or including cure provisions, than the publicly held debtors discussed earlier.⁸⁶ Yet loss of the leverage afforded by the current panoply of default terms would significantly limit a secured creditor's ability to actively monitor, particularly with respect to intangible problems such as shirking or underperformance. Moreover, Adler proposes to abolish the foreclosure rights of secured creditors, another important source of leverage over the debtor.⁸⁷

83. See Adler, *A New Perspective*, *supra* note 72, at 20-21.

84. This account suggests that secured creditors may often play different roles in publicly held, as opposed to closely held corporations. Even a risky publicly held corporation is likely to have a significant equity interest, thus diminishing (at least marginally) a secured creditor's risks. As a result, the secured creditors of a publicly held firm seem less likely to engage in some forms of particularly active monitoring, such as involvement in the debtor's decision-making process.

85. Scott argues that the relationship between a secured creditor and the debtor in many close corporations becomes so close as to make them almost like joint venturers. In return for the situational monopoly Article 9 gives it, the secured creditor may provide business expertise that many debtors could not otherwise afford, as well as an ongoing source of funding. Scott, *A Relational Theory*, *supra* note 61.

86. The familiar "insecurity" clause, which permits a secured creditor to declare a default if it loses confidence in a debtor's ability to repay, see U.C.C. § 1-208 (1977) (imposing a good faith limitation on exercise of insecurity clauses), is one example of a default provision that would become problematic in a contingent/chameleon equity regime.

87. Adler, *Financial and Political Theories*, *supra* note 32, at 332. Bradley and Rosenzweig propose that creditors retain their individual default rights. Bradley & Rosenzweig, *supra* note 4, at 1085 n.98. However, as Adler points out, retention by creditors of their default rights would completely undermine the contingent/chameleon equity regime, and thus seems incompatible with the proposal, since it would reintroduce the problem of races to the courthouse by creditors (and possible dismemberment of the firm). Adler, *Financial and Political Theories*, *supra* note 32, at 332-33.

In effect, contingent/chameleon equity shifts authority to a firm's unsecured creditors, because they, rather than the secured creditor, will decide the firm's fate in the first instance in the event of a default. Unsecured creditors' newfound authority would force them to take a much more active role in the monitoring process. Rather than relying primarily on the secured bank, unsecured creditors would be required to negotiate with the debtor over the terms of her continued employment, to find new managers, or to move forward with liquidation. The prospect of this responsibility would require more active involvement throughout the life of the loan.⁸⁸

Contingent/chameleon equity thus substitutes a regime with many active monitors for one with a single active monitor and numerous passive ones.⁸⁹ Moreover, many of these monitors—trade creditors in particular—are particularly unlikely to shoulder this responsibility effectively.⁹⁰ By undermining the role of secured credit, and reinjecting unsecured creditors into the process, contingent/chameleon equity would significantly increase the overall cost of credit in closely held firms.

In theory, the parties could simply agree among themselves to vest decision-making authority in the secured creditor if they wished. Moreover, if a closely held firm is truly in financial trouble, the secured creditor could end up in control even in the absence of such an agreement, since unsecured creditors (as the new shareholders) may not find it in their interest to cure all of the firm's defaults. Rather than vindicating contingent/chameleon equity, however, these arguments reinforce the earlier conclusion that the proposal is particularly unsuited for closely held firms. If broader secured creditor control is desirable, a better solution would achieve this objective directly.

88. In the alternative, unsecured creditors might simply fail to monitor, or monitor very little, because (due to its abolition of individual default rights) contingent/chameleon equity does not permit any individual creditor to reap the rewards of its monitoring. Rather, monitoring becomes a collective good that must be shared with the entire class. Stated differently, contingent/chameleon equity reintroduces, and arguably exacerbates, the very collective action and duplication of effort problems that secured credit currently helps to solve. See Levmore, *supra* note 71, at 55-57.

89. Or, as suggested in the previous footnote, it might create a regime that lacks any sufficiently active monitor, if no unsecured creditor assumes the monitoring responsibility.

90. See Schwartz, *Security Interests and Bankruptcy Priorities*, *supra* note 71, at 11 n.28; Levmore, *supra* note 71, at 53.

D. A World with No Bankruptcy

Eliminating bankruptcy and relegating the parties to the state law collection regime, as Bowers suggests, holds promise in cases involving a debtor and a secured creditor that is likely to be undersecured in the event of a default. In these cases, bankruptcy often simply postpones an inevitable liquidation and, in doing so, generates significant deadweight costs. Because the secured creditor has an incentive to liquidate only if long term prospects are bleak, its decision arguably should be respected in the first instance.

Bowers does not limit his critique of Chapter 11 to this context, however. His view of the debtor as the best liquidator argues for abolition of bankruptcy in a much broader array of cases. The first problem with his proposal is that its predictions conflict with observed reality. Bowers posits that debtors will use security as a means of insuring optimal liquidation in the event of loss. They may grant security in key assets—that is, assets essential to a debtor's business—to creditors likely to be among the last to liquidate and leave less critical, more easily liquidated assets (such as accounts receivable) to aggressive creditors.⁹¹ In practice, however, debtors who use secured credit frequently give blanket security interests to their financing lender.⁹² One rarely observes the subtle apportioning of security interests that Bowers's analysis has in mind.

More importantly, the proposal would lead to the dismemberment of many corporations that are more valuable as going concerns. Medium-sized and large firms would be particularly vulnerable in this respect. Given their fixed upside return, many creditors would have little incentive to wait patiently as the debtor sought either to renegotiate or to arrange a sale of the firm. State law grace periods and other stalling techniques, which might afford adequate time for firms that need only negotiate with or cure defaults with respect to one or two key creditors, would not give the managers of firms with more numerous and diverse creditors adequate breathing space to forestall a piecemeal liquidation.⁹³

91. Bowers, *Loss Distribution*, *supra* note 21, at 66-67.

92. Article 9 affirmatively promotes the use of blanket security interests by not only enabling a secured creditor to take a security interest in all of a debtor's present and after acquired assets, but also giving future advances the same priority as the original loan (with some exceptions) if the loan includes a future advances clause. U.C.C. §§ 9-204, 9-312(5) (1977).

93. The use of a "prepackaged bankruptcy" approach—that is, negotiating a confirmable plan prior to filing for bankruptcy—appears to suffer from closely analogous limitations. Because of the bargaining obstacles, the approach is most effective if one, rather than multiple, class of creditors' interests are primarily at stake.

History suggests an additional problem, one which also would be particularly acute outside of the context of closely held firms. Prior to the enactment of section 77B of the Bankruptcy Act in 1934, the fate of financially distressed firms was played out almost exclusively in state foreclosure and receivership proceedings and their federal counterparts.⁹⁴ In other words, businesses once operated in a regime strikingly similar to the one currently proposed.⁹⁵ The widespread perception that this system facilitated collusion sparked the decision to undertake a vast reformation of the nation's insolvency laws. Critics of the equity receivership process were particularly concerned that management and senior creditors conspired to squeeze out bondholders and other widely dispersed investors.⁹⁶

While investors are probably less vulnerable now than they were in the early decades of the century, one suspects that strategic behavior might once again become a more pressing problem in the absence of bankruptcy. This threat, together with the risk of undesirable and unnecessary dismemberment, makes elimination of bankruptcy a particularly unattractive alternative for all but a limited class of closely held firms.

E. Summary

Each of the new proposals to replace Chapter 11 is problematic in important respects. Both the auction proposals and contingent/chameleon equity hold promise only for publicly held corporations. Even in that context, mandatory auctions would suffer from a lack of bidders; and contingent/chameleon equity assumes the existence of smoothly functioning markets for the equity of an insolvent debtor, and would give rise to significant strategic behavior problems even if the assumption held true. In contrast to auctions and contingent/chameleon equity, eliminating

It might be argued that the parties themselves could negotiate around the problem by agreeing in advance not to exercise their foreclosure rights on default. Even if such a solution were possible (which is questionable under current law, since the original creditors could not bind subsequent creditors to the scheme), it would defeat the whole point of Bowers's approach, which emphasizes the value of *individual* collection.

94. See 8 SECURITIES AND EXCHANGE COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES 5-9 (1940) [hereinafter SEC REPORT].

95. The Bankruptcy Act of 1898 was in place during this time, and provided a federal bankruptcy law, but it was not geared for the reorganization of corporations with publicly held securities and was rarely used in that context. *Id.* at 62-81.

96. See, e.g., DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 35 (2d ed. 1990); *Northern Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913).

bankruptcy makes no sense for a publicly held corporation, although it does seem attractive for some closely held firms.⁹⁷

Given the limited range of firms for which each might prove at least marginally effective, it is tempting to mix and match the proposals: to propose contingent/chameleon equity for publicly held corporations, for instance, and the elimination of Chapter 11 in the context of closely held firms. Another possibility would be to permit each firm to decide for itself, that is, to include the proposals in a menu of bankruptcy options for firms to choose from in connection with their initial incorporation.⁹⁸ Each of these possibilities would be far from perfect, yet they raise an important practical question. Assuming that commentators developed an alternative that clearly was superior to Chapter 11, would Congress recognize this and actually adopt it? I address this question in the following part and in doing so, shed additional light on the proposed alternatives to Chapter 11.

III. THE POLITICS OF BANKRUPTCY

In this part, I move from a normative analysis of each of the proposals to the more practical question posed at the conclusion of the previous part: Is it plausible to assume that Congress would adopt any proposal that jettisoned Chapter 11? Based on an analysis drawn from the public choice literature, Barry Adler contends that it is not, concluding instead that interest group pressures would and will thwart any effort to adopt even a more efficient insolvency process.⁹⁹ I argue that he ultimately is right, at least with respect to the current proposals, but for the wrong reasons. I begin by critiquing his public choice analysis.

97. The preplanned capital structure proposal does not seem more appropriate for either close or publicly held corporations. While the risk of bankruptcy is likely to be greater in the close corporation context, sophisticated capital structure adjustments seem more likely to be useful for publicly held corporations. Unfortunately, the negotiating costs and the difficulty of making midstream adjustments would probably outweigh the proposal's benefits in either context.

98. This is the approach Rasmussen would implement. Rasmussen, *supra* note 29.

99. Adler, *Financial and Political Theories*, *supra* note 32, at 341-46.

A. Public Choice and Bankruptcy Legislation

I. LIMITATIONS OF THE STANDARD INTEREST GROUP APPROACH

In its simplest form, public choice theory posits that legislation (or the failure to enact legislation)¹⁰⁰ frequently benefits concentrated, well-organized interest groups at the expense of more diffuse interests. Although the total cost of the legislation to a diffuse group may exceed its benefits to the more concentrated one, the cost to each individual member of a diffuse group is small. As a result, the diffuse group members do not have sufficient incentives to generate effective opposition.¹⁰¹

Adler argues that two concentrated groups, the corporate and bankruptcy bars and corporate managers, benefit from the current, inefficient version of Chapter 11. The corporate and bankruptcy bars have a significant sunk investment in their expertise with respect to extant laws, and thus can be expected to oppose any move from the status quo.¹⁰² Corporate managers are likely to challenge any proposal that diminishes their control over a corporate debtor. Contingent/chameleon equity has precisely this effect: Unlike Chapter 11, which permits managers to stay in charge, contingent/chameleon equity would subject managers to a vote of confidence and likely dismissal in the event of default. As a result, the prospect of its adoption also would provoke aggressive opposition from managers.¹⁰³

By contrast, investors such as shareholders and bondholders would favor an improved bankruptcy procedure, since elimination of the inefficiencies of Chapter 11 would increase the present value of their investments.¹⁰⁴ Unlike the corporate and bankruptcy bars and corporate

100. See Robert D. Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339, 367 (1988) (emphasizing that public choice analysis does not focus simply on the passage of legislation).

101. *Id.* at 343. See also Sam Peltzman, *Towards a More General Theory of Economic Regulation*, 19 J. LAW & ECON. 211 (1976); George T. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

102. Adler, *Financial and Political Theories*, *supra* note 32, at 343-44.

103. *Id.* at 344-45.

104. In addition to the direct effect on shareholders' current investments, an improved insolvency regime would marginally increase the value of all corporations. Cf. Donald E. Schwartz, *In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley*, 71 CORNELL L. REV. 322, 331 (1986) (arguing that derivative litigation is justified in large part by its general, ex ante deterrent effect). In theory, one would expect shareholders to be most concerned about their current investments, since the price of any future investments should reflect the value of an improved regime. In practice, they appear to be interested in improving the future

managers, however, both of whom are well organized and have concentrated interests in the status of bankruptcy law,¹⁰⁵ investors are poorly organized, and each has only a limited stake; the interest of each investor amounts only to the increased recovery she could expect under a more efficient insolvency regime, multiplied by the (relatively small) probability that insolvency will in fact occur.¹⁰⁶ According to Adler, well-organized bankruptcy lawyers and corporate managers will outcompete diffuse investors for the ears of their legislators and would stymie any effort to adopt a superior law.¹⁰⁷

Even on its own terms, the story is problematic in several respects. First, at least in the context of publicly held firms, investors are not nearly so diffuse and disorganized as Adler represents. Institutional investors have in recent years accumulated significant percentages of the stock (as well as debt instruments) of America's publicly held corporations.¹⁰⁸ In the corporate law context, such investors have taken an active role in opposing antitakeover provisions and other measures that they see as inconsistent with their interests.¹⁰⁹ While it is unclear whether institutional investors would have sufficient incentives to make a similar stand with respect to bankruptcy reform, the potential benefits

playing field as well.

105. Unlike investors, managers and corporate and bankruptcy attorneys are limited in their ability to diversify their interests to reduce their risks. Managers in particular may have a large proportion of their tangible and intangible assets invested in the firm they manage. Lawyers can diversify more easily: Should bankruptcy law change dramatically or disappear, they could develop a nascent expertise in litigation or tax law; but they also are at risk, especially in a difficult economic climate. It is in this sense, together with the fact that both groups are relatively discrete, that managers' and corporate and bankruptcy lawyers' interests are particularly concentrated.

106. As suggested in the preceding footnote, investors such as shareholders and bondholders also are much better able to diversify their investments and thus to significantly reduce their risk.

107. Adler, *Financial and Political Theories*, *supra* note 32, at 343-46.

108. See Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 447-50 (1991); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992) [hereinafter Black, *Agents Watching Agents*]; Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990) [hereinafter Black, *Shareholder Passivity*].

109. Everyone agrees that institutional shareholders have begun to play a much more important role in corporate governance in recent years. Where the commentators join issue is in their predictions as to how much this activism will actually improve the management of publicly held corporations. Compare Rock, *supra* note 108 (pessimistic view of institutional shareholder involvement) with Black, *Agents Watching Agents*, *supra* note 108 (optimistic assessment of institutional shareholders' current and future role) and Black, *Shareholder Passivity*, *supra* note 108 (same).

of an improved regime and the relatively low cost of registering their support suggest that managers and the bar may face greater opposition from these investors than Adler envisions.¹¹⁰

Another interest group whose presence is omitted from the story is banks and other financial institutions. Banks are notoriously well organized and effective as lobbyists. Among other credits, they are widely seen as having heavily influenced the rules governing secured transactions in Article 9 of the UCC. While banks are relatively satisfied with their treatment in Chapter 11, they frequently complain about the expense and delay of the bankruptcy process. One suspects that banks would aggressively support legislation that addressed these problems with Chapter 11. Along with institutional investors, they could provide a powerful counterbalance to managers and the corporate and bankruptcy bars.¹¹¹

A much more important problem with the standard public choice opposition between concentrated and diffuse groups is its failure to acknowledge a crucial piece in the bankruptcy legislation puzzle: the role of populist ideology. In the article that inspired the title of Adler's piece, Mark Roe suggests that "[t]he implicit public choice assumption that ideology doesn't count, or doesn't count much, is usually correct. But when the broad mass of average people have *even a weak preference and*

110. In the final version of his article, Adler acknowledges the lobbying power of institutional investors (and banks, which are discussed in the following paragraph). However, he concludes that, because most firms do not become insolvent, the cost of bankruptcy to these investors is too small to warrant significant reform activity on their part. Adler, *Financial and Political Theories*, *supra* note 32, at 342. Yet it is not entirely clear that this is true. Rock has pointed out that institutional shareholder activism is most pronounced with respect to issues whose value increasing or decreasing effect is clear, and which can be generalized across a wide range of firms (as opposed to being firm specific and thus requiring a nontransferable investment by the shareholders). Rock, *supra* note 108, at 485. Shareholder opposition, in the form of shareholder resolutions, to managers' use of takeover defenses is the most visible example of institutional shareholder activism with respect to such an issue. *Id.* at 481-84 (chronicling the increasing success of these resolutions in recent years). Bankruptcy reform arguably is also an example of such an issue, since it would benefit *all* of the firms in which institutional investors have an interest.

111. It is also interesting to note that although Adler is probably right that managers would resist reform, he may have overestimated lawyers' incentives to behave similarly. Corporate and bankruptcy lawyers have already made a substantial investment in mastering the current laws, as he suggests, but lawyers as a whole have a strong interest in promoting change. See, e.g., Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 504-05 (1987). The uncertainty created by a new insolvency regime would generate substantial new fees both because of its litigation-enhancing effect and because clients would look to attorneys for advice as to the likely impact of the system. None of the proposals would so simplify all aspects of the process as to eliminate these considerations.

that preference is the same for most people, then ideology does matter."¹¹² In Roe's view, politicians will respond to a perspective that is sufficiently widely held, even if the individuals are unorganized and widely scattered. He argues that populist distaste for concentration of power in the hands of large financial institutions provided a key stimulus for the laws limiting banks' and other financial institutions' ability to acquire large blocks of stock in American corporations.¹¹³

The populism story is particularly applicable in the bankruptcy context. As with large financial institutions, Americans are inherently distrustful of the managers of major corporations. This traditional distrust has spawned populist heroes such as William Jennings Bryan, Louis Brandeis, and William Douglas throughout the nation's history, and has most recently manifested itself in the widespread outrage at the astronomical salaries paid to the managers even of struggling corporations.¹¹⁴ The current hostility to managers has led both to shareholder referendums on management compensation and to a Securities and Exchange Commission proposal that corporations be required to give a clearer picture of management compensation in their public disclosures. The public is hardly more sympathetic to lawyers in general and to the bankruptcy bar in particular.¹¹⁵ In short, pervasive concern about managerial accountability and professionals' fees in bankruptcy is a force that must be reckoned with in assessing the prospects for bankruptcy reform.

Moreover, the history of bankruptcy in this country offers powerful confirming evidence that populist ideology looms large in the legislative process.¹¹⁶ Almost all of the key reforms implemented by the Chandler

112. Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 31 (1991) (emphasis in original).

113. *Id.* at 32-36. See also Arthur T. Denzau & Michael C. Munger, *Legislators and Interest Groups: How Unorganized Interests Get Represented*, 80 AM. POL. SCI. REV. 89 (1986) (arguing that voters who have policy preferences are represented even if not organized, because interest groups will focus their attention on legislators whose constituency is indifferent as to the issue in question).

114. See GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF THE AMERICAN EXECUTIVES (1991). President Bush's early 1992 trip to Japan served as a lightning rod for public anger. Both the American and the Japanese press were quick to point out that the American automobile executives who accompanied Bush made far more in running much less healthy companies than did their Japanese counterparts.

115. See, e.g., Donald L. Barlett & James B. Steele, *The Lucrative Business of Bankruptcy*, PHILA. INQ., Oct. 21, 1991, at 1A (second article in series entitled "America: What Went Wrong?") (arguing that the "winners" in the surge of bankruptcies caused by the heavy debt of the 1980s are high priced consultants and lawyers).

116. For another context in which populism proved crucial, see JOHN W. KINGDON, AGENDAS, ALTERNATIVES, AND PUBLIC POLICIES 9-13 (1984) (describing how populist distrust of big government led to the deregulation of the airline and trucking

Act of 1938 were directed at managers and the corporate and bankruptcy bars, whom future Justice Douglas in particular lambasted as ruthless and concerned only for their own profits.¹¹⁷ Chapter X required both that the managers of a bankrupt debtor be replaced by an independent trustee in every case within its purview, and that the Securities and Exchange Commission intervene if the debtor's liabilities exceeded \$3 million to ensure the fairness of the reorganization process.¹¹⁸ The infringements on managerial discretion ushered in by the Chandler Act could not have been more complete, yet they passed despite the vitriolic objections of managers and the bankruptcy bar, who insisted the provisions would hopelessly bog down the reorganization process.¹¹⁹

The legislative environment of the 1990s obviously differs significantly from that of the 1930s—populism was particularly potent in the midst of the Depression. Yet populism has not disappeared and, as discussed above, appears to have acquired particular force in the wake of the excesses of the past decade. In addition to considering all of the relevant interest groups, including the pressure applied by institutional investors and banks, a more complete public choice story must therefore also account for the widespread popular antipathy toward managers and attorneys. Focusing in particular on the contingent/chameleon equity alternative to Chapter 11, I suggest such a story in the following subsection.

2. ANOTHER LOOK AT PUBLIC CHOICE: THE CASE OF CONTINGENT/CHAMELEON EQUITY

Adler suggests that, even if interest group obstacles might be overcome in the bankruptcy context, the current status of several areas of *nonbankruptcy* law would preclude adoption of the contingent/chameleon

industries despite the countervailing pressure of interest groups such as truckers and the Teamsters).

117. See WILLIAM O. DOUGLAS, *DEMOCRACY AND FINANCE* 175-80 (1940) (criticizing management control of the reorganization process); I SEC REPORT, *supra* note 94, at 4 ("Reorganizers frequently have not been concerned, in the manner of investors, with economy in reorganization, as economy would interfere with their profits.").

118. See, e.g., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, 93d Cong., 1st Sess. 244-47 (1973) [hereinafter 1973 COMMISSION REPORT].

119. Robert T. Swaine, "Democratization" of Corporate Reorganizations, 38 COLUM. L. REV. 256, 277 (1938). Swaine also complained, among other things, that "[m]anagement having thus been turned out, there is to be substituted, not action determined by free negotiation of the securityholders among themselves under leadership chosen by them, but complete SEC domination of the reorganization process." *Id.* at 260.

equity proposal he advocates. Other reform might be possible, but not the regime he sees as optimal.¹²⁰

The most important of these barriers is the Internal Revenue Code. The tax laws have long allowed corporations to deduct the amounts they pay as interest on debt, but do not permit deductions for dividends, thus giving firms a considerable incentive to issue debt rather than equity.¹²¹ A contingent/chameleon equity firm would forego traditional debt in favor of fixed claims convertible into stock in the event of a default. Adler contends that the IRS almost certainly would treat these claims as equity rather than debt under the tax code, and would deny the debt deduction.¹²² Given the huge cost to corporations were they to lose this deduction, he concludes, contingent/chameleon equity reform would only be attractive if it also assured that firms would not be penalized from a tax perspective.

Adler assumes that the only way to achieve this effect would be for legislators either to eliminate taxation at the corporate level altogether (either directly or by granting tax credits to investors), or to eliminate the interest deduction. He suggests that politicians have little incentive to abolish corporate level taxation, due to the leverage it gives them over corporate managers,¹²³ and that the interest deduction may be protected by deep-seated populist support.¹²⁴

120. In addition to the tax issue discussed in the text below, Adler argues that the parties' inability to bind themselves and future creditors to a contingent/chameleon equity scheme precludes its adoption under current law. This impediment obviously would disappear if Congress explicitly authorized contingent/chameleon equity. For a discussion of another of the impediments, the treatment of tort claimants, see *infra* note 127.

121. 26 U.S.C. § 163(a) (1988); see also WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE* 317-18 (4th ed. 1990) (noting that current tax laws give firms an almost irresistible incentive to leverage).

122. Adler, *Financial and Political Theories*, *supra* note 32, at 334-35 (noting that 26 U.S.C. § 385(b)(1) defines debt to require an unconditional promise to pay).

123. *Id.* at 345 (following Doernberg and McChesney). Fred McChesney contends that legislators sometimes threaten to withdraw benefits from an interest group so as to force the group to "pay" the legislators for a continuation of the status quo. Fred S. McChesney, *Rent Extraction and Interest-Group Organization in a Coasean Model of Regulation*, 20 J. LEGAL STUD. 73 (1991). McChesney and Richard Doernberg suggest that corporate taxes are particularly amenable to legislator rent-seeking of this sort. Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913 (1987).

124. Adler, *Financial and Political Theories*, *supra* note 32, at 346. Drawing from a recent article by Daniel Shaviro, see Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 60-61 (1990), Adler argues that American voters are willing to deny deductibility to dividends but grant it to interest on debt because they associate dividends with the wealthy, whereas interest expense is a cost with which they themselves are familiar.

This analysis is problematic in two related respects. First, it is not at all clear that contingent/chameleon equity would in fact be denied debt status. In giving the Treasury authority to define precisely when a security is or is not debt under § 385 of the Internal Revenue Code, Congress suggested that the Treasury take several factors into consideration, including 1) the existence of a written, unconditional promise to pay on a reasonable certain date, at a fixed rate of interest; 2) whether the security is subordinated or preferred; 3) the ratio of debt to equity; 4) convertibility; and 5) the relationship between investors' holdings of stock and of the securities in question. As the catalogue suggests, no single factor is dispositive in determining whether a given security constitutes debt.¹²⁵ In this environment, contingent/chameleon equity seems very likely to qualify for the interest deduction, especially given the facts that conversion occurs only on default and that the securities are not designed for tax avoidance purposes.¹²⁶ Second, even if the securities failed to qualify as debt, a much simpler proposition than eliminating corporate level taxation or the interest deduction would be for Congress to amend the tax code's definition of debt to explicitly include fixed claims against a contingent/chameleon equity firm.¹²⁷

To appreciate why legislators might adopt such a measure, consider the following story. Assume that institutional shareholders and debtholders press Congress to consider replacing bankruptcy with a contingent/chameleon equity regime, much as they have lobbied for SEC action and changes at corporations like Sears, Roebuck, and General Motors.¹²⁸ Banks also lobby aggressively in support of the proposals.

125. BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 4.02, at 4-11, 12 & 14 (1987). Interestingly, although the Treasury issued regulations for § 385 of the Internal Revenue Code, it subsequently withdrew them. Courts therefore still are left to their own devices in determining whether a security qualifies as debt.

126. See, e.g., BITTKER & EUSTICE, *supra* note 125, § 4.03, at 15-20. The leading academic commentary on this issue, although dated in some of its details, is a massive work by William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971).

127. Another of the barriers cited by Adler relates to the current treatment of tort claimants. Adler suggests that, because adoption of the proposal would effectively subordinate holders of contingent/chameleon equity to tort claimants, since tort claimants currently are deemed to be unsecured creditors, shareholders might be hesitant to support contingent/chameleon equity. Adler, *Financial and Political Theories*, *supra* note 32, at 339-40. This problem would also disappear if contingent/chameleon equity were afforded debt status. Moreover, as Adler acknowledges in the final version of his article, even if subordination of this sort were unavoidable, shareholders still might not be chilled, since the likelihood of massive tort liability for most firms is relatively small. *Id.* at 340.

128. See, e.g., Francine Schwadel, *Sears Roebuck Settles Lawsuit over Directors*, WALL ST. J., Oct. 28, 1991, at A9B (agreement by Sears to make "substantial

equity proposal he advocates. Other reform might be possible, but not the regime he sees as optimal.¹²⁰

The most important of these barriers is the Internal Revenue Code. The tax laws have long allowed corporations to deduct the amounts they pay as interest on debt, but do not permit deductions for dividends, thus giving firms a considerable incentive to issue debt rather than equity.¹²¹ A contingent/chameleon equity firm would forego traditional debt in favor of fixed claims convertible into stock in the event of a default. Adler contends that the IRS almost certainly would treat these claims as equity rather than debt under the tax code, and would deny the debt deduction.¹²² Given the huge cost to corporations were they to lose this deduction, he concludes, contingent/chameleon equity reform would only be attractive if it also assured that firms would not be penalized from a tax perspective.

Adler assumes that the only way to achieve this effect would be for legislators either to eliminate taxation at the corporate level altogether (either directly or by granting tax credits to investors), or to eliminate the interest deduction. He suggests that politicians have little incentive to abolish corporate level taxation, due to the leverage it gives them over corporate managers,¹²³ and that the interest deduction may be protected by deep-seated populist support.¹²⁴

120. In addition to the tax issue discussed in the text below, Adler argues that the parties' inability to bind themselves and future creditors to a contingent/chameleon equity scheme precludes its adoption under current law. This impediment obviously would disappear if Congress explicitly authorized contingent/chameleon equity. For a discussion of another of the impediments, the treatment of tort claimants, see *infra* note 127.

121. 26 U.S.C. § 163(a) (1988); see also WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE* 317-18 (4th ed. 1990) (noting that current tax laws give firms an almost irresistible incentive to leverage).

122. Adler, *Financial and Political Theories*, *supra* note 32, at 334-35 (noting that 26 U.S.C. § 385(b)(1) defines debt to require an unconditional promise to pay).

123. *Id.* at 345 (following Doernberg and McChesney). Fred McChesney contends that legislators sometimes threaten to withdraw benefits from an interest group so as to force the group to "pay" the legislators for a continuation of the status quo. Fred S. McChesney, *Rent Extraction and Interest-Group Organization in a Coasean Model of Regulation*, 20 J. LEGAL STUD. 73 (1991). McChesney and Richard Doernberg suggest that corporate taxes are particularly amenable to legislator rent-seeking of this sort. Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913 (1987).

124. Adler, *Financial and Political Theories*, *supra* note 32, at 346. Drawing from a recent article by Daniel Shaviro, see Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 60-61 (1990), Adler argues that American voters are willing to deny deductibility to dividends but grant it to interest on debt because they associate dividends with the wealthy, whereas interest expense is a cost with which they themselves are familiar.

This analysis is problematic in two related respects. First, it is not at all clear that contingent/chameleon equity would in fact be denied debt status. In giving the Treasury authority to define precisely when a security is or is not debt under § 385 of the Internal Revenue Code, Congress suggested that the Treasury take several factors into consideration, including 1) the existence of a written, unconditional promise to pay on a reasonable certain date, at a fixed rate of interest; 2) whether the security is subordinated or preferred; 3) the ratio of debt to equity; 4) convertibility; and 5) the relationship between investors' holdings of stock and of the securities in question. As the catalogue suggests, no single factor is dispositive in determining whether a given security constitutes debt.¹²⁵ In this environment, contingent/chameleon equity seems very likely to qualify for the interest deduction, especially given the facts that conversion occurs only on default and that the securities are not designed for tax avoidance purposes.¹²⁶ Second, even if the securities failed to qualify as debt, a much simpler proposition than eliminating corporate level taxation or the interest deduction would be for Congress to amend the tax code's definition of debt to explicitly include fixed claims against a contingent/chameleon equity firm.¹²⁷

To appreciate why legislators might adopt such a measure, consider the following story. Assume that institutional shareholders and debtholders press Congress to consider replacing bankruptcy with a contingent/chameleon equity regime, much as they have lobbied for SEC action and changes at corporations like Sears, Roebuck, and General Motors.¹²⁸ Banks also lobby aggressively in support of the proposals.

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128. See, e.g., Francine Schwadel, *Sears Roebuck Settles Lawsuit over Directors*, WALL ST. J., Oct. 28, 1991, at A9B (agreement by Sears to make "substantial

Each of these interest groups insists that reform is the only way to ensure that the managers of a giant corporation are adequately penalized for financial failure, and to eliminate lawyers' outrageous fees in bankruptcy.¹²⁹

Managers and the bankruptcy bar are well organized and have more at stake than any other group, and they would strongly counter this pressure. Their familiarity with the legislators and their presence even on drafting committees would make them a formidable influence. Yet Congress could hardly afford to ignore the widespread antipathy toward managers and lawyers.

One solution might be for legislators to adopt the reform, but to give firms the choice whether to use contingent/chameleon equity or to stay with the current regime,¹³⁰ and to preserve the interest deduction for firms that invoked the contingent/chameleon equity option. This would enable Congress to extract rents from each of the relevant interest groups, without completely alienating any one. Moreover, as Fred McChesney has pointed out, organization is not an unequivocal advantage. While effective organization vastly enhances the influence of groups such as managers and attorneys, it also increases the ease with which rents can be extracted from them.¹³¹ From this perspective, Congress's interest in collecting future rents might give it a particularly strong incentive to destabilize the status of managers and bankruptcy attorneys as described above.

This story is obviously just that, a story. It is at least plausible that managers and the corporate and bankruptcy bars are sufficiently powerful, and would be sufficiently creative in packaging their appeal to Congress,¹³² to thwart any proposed change. What becomes clear as

improvements" in corporate governance in settlement of suit challenging its treatment of Robert Monks's dissident campaign for a seat on the board).

129. See, e.g., GORDON TULLOCK, *THE ECONOMICS OF SPECIAL PRIVILEGE AND RENT SEEKING* 23 (1989) ("[American voters] are apt to vote, if the matter is brought to their attention, in terms of ideology. It is important that the measure be packaged in such a way that it appears to them to be somehow in accord with their ideology.").

130. Notice that many state antitakeover provisions adopt an analogous "opt in" or "opt out" approach. See 15 PA. CONS. STAT. § 2571 (1990). If contingent/chameleon equity actually improved on Chapter 11, market forces might pressure firms to use it, just as similar pressures caused many corporations to opt out of the Pennsylvania antitakeover provision. See, e.g., Barbara Demick, *Study Links Loss by Pennsylvania Stocks to the Takeover Law*, PHILA. INQ., Oct. 12, 1990, at 1D (more than 80 firms opted out of some or all of the protections). As the following section makes clear, however, such a scenario would be unlikely with contingent/chameleon equity, given the problems with the proposal.

131. McChesney, *supra* note 123, at 88.

132. For instance, management might raise arguments of the sort discussed in the following section, in an effort to fend off reform. Such arguments would probably prove

the public choice analysis is fleshed out, however, is that this assertion is at best a debatable one. If none of the proposals is politically viable, it may therefore be for very different reasons.

B. The Myth of a Self-Regulating Insolvency Procedure

In his recent article on the Delaware Supreme Court's watershed corporate law decision in *Paramount Communications, Inc. v. Time Inc.*,¹³³ Jeffrey Gordon concludes that a "socio-historical" account better explains the court's actions than either the standard or a more sophisticated version of public choice analysis.¹³⁴ In this section, I use a variant of this analysis to demonstrate what ultimately is the fatal flaw with the proposed alternatives to Chapter 11, and why none is likely to be enacted.

Gordon derives his socio-historical thesis from *The Great Transformation*,¹³⁵ Karl Polanyi's historically-based analysis of the relationship between market economies and government intervention.¹³⁶ Polanyi contends that a market economy cannot exist apart from regulation. Regulation is necessary both to establish the market and, more importantly for present purposes, to prevent it from spiralling out of control, from causing catastrophic dislocations in society, as it would were it permitted to become truly self-regulating.¹³⁷ Gordon argues that the corporate takeover market of the 1980s began to assume many of the characteristics of a self-regulating market. The magnitude and abruptness of the changes in corporate control created a widespread perception that the market had lost its moorings and had begun to reward the pursuit of individual gain at the expense of less easily quantifiable societal values

powerful, yet their effectiveness stems not so much from managerial skill at deluding the public, cf. TULLOCK, *supra* note 129, at 23; Shaviro, *supra* note 124, at 57-64 (describing systematic cognitive misperceptions by taxpayers), as from critical shortcomings in the proposal itself.

133. 571 A.2d 1140 (Del. 1989).

134. Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931 (1991).

135. POLANYI, *supra* note 9.

136. Polanyi focuses on the development of a market economy in connection with the Industrial Revolution of the 19th Century as a means of trying to explain the events that led to the rise of fascism after World War I and immediately prior to World War II. According to Polanyi, the market economy did not develop naturally, as laissez faire economists have contended. Rather, it depended upon the commoditization of land, labor and capital, and created an irresolvable tension between the market and human rights. Polanyi argues that the resultant deadlock facilitated the emergence of fascism. *Id.*

137. *Id.* at 141.

such as loyalty, continuity, and community.¹³⁸ From this perspective, the court's decision in *Paramount*, which gives the directors of a target corporation broad authority to reject a hostile takeover bid, can be seen as the kind of regulatory response the Polanyi thesis would predict. Interposing the human agency of the target directors was the court's way of restraining some of the excesses of an entirely market-driven regime.

Gordon's application of the Polanyi thesis sheds important light on Congress's likely response to the proposed alternatives to Chapter 11. Each of the alternatives would implement a market-based, self-regulating insolvency regime in place of the current judicially-oriented Bankruptcy Code. The preplanned adjustment, contingent/chameleon equity, and elimination of bankruptcy proposals attempt to obviate the need for court or other judicial involvement altogether.¹³⁹ (I will refer to these as the pure market proposals). The mandatory auction proposal retains a role for the court, which would arbitrate the parties' entitlement disputes, but depends upon the very same market dynamic, the corporate takeover, that *Paramount* arguably calls into question.

Seen in this light, the proposals seem particularly precarious from a political perspective. Given the pervasive concern about the consequences of a self-regulating system of corporate law outside of bankruptcy, one suspects that Congress would reject any system that appears simply to transplant these perceived corporate law excesses, with their threat of job loss and business shutdown, into the bankruptcy domain.¹⁴⁰ The assumption in American bankruptcy law at least since the enactment of the Chandler Act in 1938 that state involvement in the person of a bankruptcy judge is needed to facilitate and protect the reorganization process strongly reinforces this suspicion. More regulation, rather than less, may well be the order of the day.¹⁴¹

138. Gordon, *supra* note 134, at 1972.

139. Bradley and Rosenzweig make this aspiration explicit: "An important feature of our proposal, distinct from others, is that it *completely avoids* judicial intervention." Bradley & Rosenzweig, *supra* note 4, at 1085 (emphasis in the original).

140. Whether the concerns about the takeover market may be overstated, or even wholly inaccurate, is a matter of much dispute. The important point for present purposes is that many politicians and a broad segment of the public perceive the escalation of takeover activity to have been a dangerous and disruptive phenomenon.

141. In theory, the analysis could also be interpreted to predict that Congress perhaps will enact one of the proposals, but, were this to happen, courts or Congress itself would subsequently act to reign in the self-regulating market the proposal had created. The most obvious way to reign in the proposals would be for courts to limit their operation, as for instance by granting shareholders' suits to enjoin the actual cancellation of equity following an apparent default. While this hypothetical chain of events arguably fits the Polanyi thesis more closely than the analysis in the text, one suspects that Congress would simply reject the proposals in the first instance.

One could argue that the concerns underlying this conclusion are misguided and, ironically, are *most* unwarranted with respect to a fully self-regulating regime such as contingent/chameleon equity. Stockholders would lose their interests were a contingent/chameleon firm to default, and unsecured creditors become stockholders, but an otherwise viable firm could continue operating with a pared down financial structure, almost without breaking stride. By contrast, Chapter 11 is costly, time consuming, and contentious. Thus, the argument might conclude, adoption of a pure market proposal, and removal of judicial intervention, could prove both more efficient and less disruptive to intangible social values than Chapter 11.

Unfortunately, the defense conceals a pair of related flaws, which erase the normative appeal of the proposals and further call into question their prospects for being enacted. First, as Polanyi pointed out with respect to the transition to a market economy generally, the promise of a truly self-regulating insolvency system is illusory.¹⁴² Consider the contingent/chameleon equity proposal once again. If a contingent/chameleon firm defaulted, its shareholders would not simply stand idly by as their equity was cancelled and their shareholder status shifted upward within the firm. On the contrary, they would frequently embroil the firm in suits as to whether a default had actually occurred, for instance, or whether creditors had waived their rights.¹⁴³ The effect of such suits would be to bring the state right back into the picture.

The other flaw is more pervasive. The pure market proposals assume that, since market players can be expected to make better asset-deployment decisions than a court would, the optimal insolvency regime is one that removes the judicial apparatus altogether. This reasoning ignores the fact that, despite being poorly positioned to make most business decisions,¹⁴⁴ courts still have a crucial role to play in an insolvency proceeding. Courts *are* well equipped to detect strategic behavior, and the current Bankruptcy Code is replete with provisions that put the court in this role. Some, such as the preference provisions, involve relatively little judicial discretion;¹⁴⁵ other sections, such as

142. POLANYI, *supra* note 9, at 141.

143. See, e.g., LoPucki, *supra* note 5, at 104-05.

144. See, e.g., Skeel, *supra* note 18, at 497 (arguing that courts should not make business decisions such as the decision whether to approve preconfirmation sales of most or all of a firm's assets in bankruptcy); Kenneth E. Scott, *Corporation Law and The American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 946 (1983) (arguing that courts are better able to police for duty of loyalty violations than for violations of the duty of care).

145. Bankruptcy Code § 547.

those dealing with fraudulent conveyances¹⁴⁶ and equitable subordination,¹⁴⁷ require the court to make extremely subjective judgments as to whether a party has acted opportunistically.

To be sure, the parties could invoke a variety of analogous nonbankruptcy statutory and common law rules as a means of policing strategic behavior even in a pure market insolvency regime. But the panoply of nonbankruptcy causes of action would fall well short of bankruptcy in three different respects. First, nonbankruptcy rules address only a limited range of the strategic behavior that occurs in the insolvency context. Fraudulent conveyance and related nonbankruptcy laws prohibit a debtor from entering into sham transactions whose effect is to transfer assets out of the estate, for instance, but are much less effective in curbing a debtor's ability strategically to favor certain legitimate creditors. Bankruptcy's more complete response to strategic behavior could be replicated, of course, outside of bankruptcy. For example, courts might use equitable subordination principles to address preinsolvency favoritism and Congress or the states could adopt preference provisions tailored to the new pure market insolvency regime.¹⁴⁸ But each of these responses presumes and necessitates a general, insolvency-triggered reassessment of the parties' respective entitlements—precisely what the pure market theories purport not to need.

Second, in the absence of bankruptcy, a party might bring a suit alleging that another creditor received a fraudulent conveyance in one jurisdiction, while a lender liability claim was filed in an entirely different forum. At the least, they will be largely disconnected cases, despite their common nexus in a financially troubled debtor. Consolidating these suits in a single court, before a single judge, offers significant judicial

146. *Id.* § 548. *Compare* Mellon Bank, N.A. v. Metro Communications, Inc., 945 F.2d 635 (3d Cir. 1991) (reversing finding that bank's financing of a leveraged buyout constituted a fraudulent conveyance) *with* Crowthers McCall Pattern, Inc. v. Lewis, 129 B.R. 992 (S.D.N.Y. 1991) (denying lender's motion to dismiss fraudulent conveyance action).

147. Bankruptcy Code § 510(c). *See, e.g.,* Unsecured Creditors' Comm. of Heartland Chem., Inc. v. Banque Paribas (*In re* Heartland Chemicals, Inc.), 136 B.R. 503 (C.D. Ill. 1992) (bank's actions in pursuing prepetition remedies did not warrant equitable subordination).

148. Adler suggests that the parties could also devise contractual responses to eliminate the possibility of strategic behavior. Adler, *Financial and Political Theories*, *supra* note 32, at 330. One problem with this approach is that the parties' attempts to anticipate and address every potential defalcation would make the contracting process enormously expensive. Moreover, as the analysis in the text makes clear, private ordering will inevitably be an inadequate substitute for ex post judicial review in the bankruptcy context. *See, e.g.,* George M. Cohen, *The Negligence-Opportunism Tradeoff in Contract Law*, HOFSTRA L. REV. 94 (forthcoming 1992).

economies.¹⁴⁹ Moreover, unlike ordinary state or federal judges, bankruptcy judges are specialists, and have particular familiarity with the end game maneuvers parties engage in prior to bankruptcy.¹⁵⁰

Third, and perhaps most importantly, the progression of a bankruptcy case gives the parties an opportunity to observe and examine the debtor (as well as one another). To facilitate this process, the Bankruptcy Code and rules require the debtor to file various forms of disclosure¹⁵¹ and provide dramatically liberalized access to the debtor's officers, employees, and files.¹⁵² Stated differently, the existence of a collectivized insolvency proceeding acts as an information forcing device which enables the parties to detect misbehavior that otherwise might have gone unnoticed, thus further reducing both the likelihood and efficacy of strategic behavior. The process also gives every constituency an opportunity to watch the firm during its transition period, and thus to reassess their relationship with the debtor; and it establishes a reckoning point against which future performance can be measured.¹⁵³

149. This conclusion should not be taken to imply that the parties must prosecute all litigation involving the debtor, of whatever nature, in the bankruptcy court. Robert Rasmussen has argued persuasively that bankruptcy courts should defer to the expertise of administrative agencies with respect to certain kinds of administrative proceedings. Robert K. Rasmussen, *Bankruptcy and the Administrative State*, 42 HASTINGS L.J. 1567 (1991).

150. The argument in the text is analogous to commentators' frequent citation of the corporate law expertise of Delaware's chancery court as one of the reasons for Delaware's continued success in attracting corporate charters. Macey & Miller, *supra* note 111, at 488-89.

151. Chapter 11 debtors are required to provide extensive, ongoing disclosure in accordance with standards the district in question has adopted under Bankruptcy Rule 9029. For other disclosure requirements, see Bankruptcy Code § 704(8) (requiring periodic reports in Chapter 7 cases); *id.* § 521 (requiring debtor to file a "schedule of assets and liabilities, a schedule of current income and current expenditures, and a statement of the debtor's financial affairs"); *id.* § 1125 (requiring plan proponent to file disclosure statement in connection with a proposed reorganization plan).

152. Bankruptcy Rule 2004. Rule 2004 has been interpreted to authorize significantly greater access to discovery than that afforded by the Federal Rules of Civil Procedure. See, e.g., *In re GHR Energy Corp.*, 33 B.R. 451, 453 (D. Mass. 1983) (examination may be "exploratory and groping").

153. An analogy can be drawn between Chapter 11 and the role of the appraisal remedy in state corporate law. The appraisal remedy has traditionally been seen as a means of insuring that shareholders who disapprove of a fundamental change and who do not wish to continue with the corporation will be bought out at a fair price. See Hideki Kanda & Saul Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429, 430-31 (1985) (discussing the traditional view and the sustained criticism it has received). Kanda and Levmore have argued that the appraisal remedy may in reality serve somewhat different purposes. In their view, some state appraisal statutes perform a "reckoning" function, and others help shareholders uncover opportunistic

In short, in their single-minded focus on introducing market efficiency into the insolvency process, the pure market proposals greatly underestimate the threat of prebankruptcy strategic behavior and bankruptcy's effectiveness as a policing mechanism. It is particularly ironic that, as discussed earlier, the proposals actually *increase* the likelihood of costly strategic behavior,¹⁵⁴ even as they undermine the parties' ability to detect, penalize, and therefore restrain it.¹⁵⁵

Recognition of the role of the bankruptcy court and of the collective proceeding provided by Chapter 11 raises a final question: Must these functions necessarily be state-sponsored? In theory, the parties themselves could develop an analogous proceeding contractually.¹⁵⁶ The parties might appoint an arbitrator, for instance, who would perform the monitoring role currently handled by a bankruptcy judge.¹⁵⁷ The parties could give the arbitrator authority to require and oversee discovery, both for detecting strategic behavior and to assess the prospects of the firm. The parties would lose the subsidy provided by a state-sponsored proceeding if they were to replicate its benefits contractually, but they would also avoid the costs of its current inefficiencies.

Unfortunately, use of a contractual arbitration proceeding ultimately seems untenable for at least two reasons. The first stems from the difficulty of establishing an effective framework. In addition to appointing an arbitrator, the parties would need to provide for a means of representing diverse and scattered claimants—in short, to replicate in some fashion Chapter 11's committee framework. Moreover, unlike a court, the arbitrator could not resolve either claims involving

behavior by the firm's managers. *Id.* at 441-44. Bankruptcy arguably does each of these things in a much less awkward (although expensive) fashion.

154. See *supra* notes 63-69, 94-96 and accompanying text.

155. The analysis in the text suggests that, as a minimum, any alternative to Chapter 11 should provide for a comparable postinsolvency collective proceeding. See, e.g., John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989) (arguing that parties should be permitted to bargain with respect to fiduciary duties, but not below a mandatory minimum standard of good faith). Notice that this would impose an important limitation on each of the choices in Rasmussen's "menu" approach.

156. As a practical matter, the difficulty of binding both present and future parties creates a serious impediment to devising such a scheme. For example, U.C.C. § 9-201 makes clear that if the debtor failed to include the arrangement in a contract with one of its secured creditors, such a creditor would not be bound. For the purposes of the discussion that follows, I put this problem to one side.

157. The drafters of the UCC are currently considering amending Article 2 to provide for mandatory arbitration in some contexts. See Letter from Paul Barron to David Skeel (July 13, 1992) (on file with author). While arbitration is more attractive in a two-party context than in one involving multiple parties, the proposal suffers from some of the defects discussed in the text below.

nonconsensual creditors, such as tort claimants, or pension claims and other nonbankruptcy issues. These limitations would severely constrain her effectiveness.

Even if the parties somehow surmounted their organizational difficulties, however, a state-sponsored system still would be superior. Unlike the contractual alternative, a state-sponsored system offers benefits not only for the case at hand, but also for future parties. The development of a rich body of precedent lowers dispute and litigation costs significantly by reducing uncertainty as to likely outcomes.¹⁵⁸ To be sure, the arbitrator inevitably would rely on existing precedent in making her determinations. But if a significant percentage of firms decided to create their own collective proceeding by contract, the precedent base would quickly begin to erode.¹⁵⁹ As a result, other things being equal, a state regime will always be preferable to its contractual counterpart.

C. Concluding Thoughts

Each of the proposed alternatives to Chapter 11 picks up on the need for a more market-based decision-making apparatus in Chapter 11. As I myself have argued, the current Bankruptcy Code too often vests decision-making authority, even with respect to what ultimately are business decisions, in the hands of the bankruptcy judge.¹⁶⁰ A better regime would shift authority in these contexts away from the court and back toward the marketplace. As our application of the Polanyi thesis has suggested, however, removing the court from the role of business decision maker does not mean that the court can or should be eliminated entirely. Both the court and the existence of a state-sponsored collective proceeding play a crucial role in the insolvency process. Coupled with their other shortcomings, the insistence of the new proposals on imposing a self-regulating market procedure makes each an inadequate substitute for the current regime.

158. See William M. Landes & Richard A. Posner, *Legal Precedent: A Theoretical and Empirical Analysis*, 19 J.L. & ECON. 249 (1976); ROBERT E. SCOTT & DOUGLAS L. LESLIE, *CONTRACT LAW AND THEORY* 8 (1988).

159. Erosion of the precedent base was one of the chief arguments against adopting separate rules for close corporations outside of bankruptcy. See Dennis S. Karjala, *A Second Look at Special Close Corporation Legislation*, 58 TEX. L. REV. 1207, 1213-27 (1980); Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365, 373 (1992).

160. Skeel, *supra* note 18, at 497-500 (unsecured creditors rather than the court should approve or disapprove preconfirmation sales of substantial assets).

IV. WHAT CAN BE DONE WITH THE BANKRUPTCY CODE?

The analysis of the preceding parts has suggested at least two crucial lessons for bankruptcy reform. First, both the proposed alternatives to Chapter 11 and Chapter 11 itself fail adequately to distinguish among close and publicly held corporations. A superior regime must function effectively in each, rather than only in one or the other, of these contexts. Second, reform must be particularly sensitive to the appropriate domains of market and of judicial decision making.

My aim in this part is to show that the drafters could better accommodate both of these goals if they scrapped the "one size fits all" approach of current Chapter 11 in favor of separate chapters for close and nonclosely held corporations. The move toward separate chapters with what I will refer to as more "context specific" rules would make it significantly easier to give decision making authority over business issues to private decision makers (i.e., the parties themselves), rather than to a court, while retaining judicial involvement with respect to those issues that courts are particularly well equipped to decide.

The proposal to establish a two corporation system has a familiar ring in the insolvency context: Both Chapters X and XI of the old Bankruptcy Act, and bankruptcy legislation recently considered by Congress distinguish between closely held and public corporations. After explaining the potential benefits of separate chapters, I conclude the part by examining both the unsuccessful Act regime and the proposed bankruptcy legislation in light of the very different two corporation system I would propose.

*A. Different Rules for Different Debtors: The Need for
Separate Closely Held and Nonclosely Held Corporation Chapters*

Corporate law commentators first called for special treatment of close corporations in states' corporation law statutes more than sixty years ago.¹⁶¹ The argument was simple: Because of their unique characteristics, close corporations are ill served by a general statute that treats all corporations as essentially equivalent. States and the drafters of the model codes have responded by enacting special provisions addressing particular close corporation issues.¹⁶²

161. See, e.g., Joseph L. Weiner, *Legislative Recognition of the Close Corporation*, 27 MICH. L. REV. 273 (1929).

162. More than 20 states currently have special provisions of one form or another for close corporations. 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 1.15, at 76 (3d ed. 1987).

Although both close and publicly held firms may one day file for bankruptcy, the Bankruptcy Code does not carry forward the corporation law policy of distinguishing between them. As a result, and as commentators have long noted, a significant number of Bankruptcy Code provisions are particularly ill suited for certain kinds of debtors. A brief discussion of two pressing issues, one relating to close corporation debtors and one to publicly held firms, should begin to illustrate the need for a more context-specific insolvency regime.

First, the close corporation context. Lynn LoPucki has shown that, despite the Code's requirement that an unsecured creditors' committee comprising seven of the debtor's largest unsecured creditors be appointed in every case,¹⁶³ courts routinely fail to appoint such committees in bankruptcies involving closely held debtors.¹⁶⁴ This failure probably reflects the lack of a sufficient incentive for unsecured creditors to participate, since their claims may be relatively small and most or all of any distribution usually goes to the firm's secured lender.¹⁶⁵ The problem is that in those cases where recovery is or would be likely, unsecured creditors may lose out because they are not represented at the bargaining table.

A regime that distinguished between close and publicly held corporations could easily address this breakdown of the committee structure. Rather than require a court to find seven willing committee members, the close corporation provision could authorize the court to appoint a single large unsecured creditor to act as the representative for the class. This creditor would have all the rights currently afforded to a committee, and would owe the same fiduciary duty to its constituency. Such a rule not only would ensure greater protection for unsecured creditors in cases where recovery is likely,¹⁶⁶ but it also would

163. Bankruptcy Code § 1102.

164. Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKR. L.J. 247 (1983).

165. Bowers, *Murphy's Law*, *supra* note 21, at 2098 n.2; DAVID T. STANLEY & M. GIRTH, *BANKRUPTCY PROBLEM, PROCESS, REFORM* 88, 127, 130 (1971) (general unsecured creditors of corporate debtors receive an average of only 8% of their claims). Bowers suggests that unsecured creditors' low recoveries are due to the likelihood that debtors have taken significant actions to distribute their losses prior to bankruptcy—that is, they have sold assets and paid various creditors. In reality, it seems more likely that the vast majority of closely held debtors' assets are tied up in a secured loan even in more prosperous times and that financial difficulties simply exaggerate this situation. Stated differently, general creditors depend upon current payment, not payment in bankruptcy, and bankruptcy results do not disappoint this expectation.

166. The question arises as to whether even a single creditor committee is appropriate in cases where unsecured creditors' interests are completely under water. The answer would appear to be affirmative for two reasons. First, the single creditor would

significantly lower the committee's costs.

Context specific rules also might greatly improve the reorganization of publicly held debtors. I have argued at length elsewhere that unsecured creditors should be given voting authority over the choice of a debtor's directors (in the event that an election is held in Chapter 11) and also with respect to the decision whether to approve a proposed preconfirmation sale of most or all of the firm's assets.¹⁶⁷ As the new residual owners of an insolvent firm, unsecured creditors could be expected to make better directorial decisions than shareholders, who are the current voters.¹⁶⁸ Their financial stake also gives them decision-making incentives superior to those of courts, which currently make what is in effect a business judgment in deciding whether to approve asset sales.¹⁶⁹ These voting proposals make sense only for Chapter 11 cases involving publicly held firms, but, in that context, both would markedly improve the effectiveness and efficiency of the decision-making process.¹⁷⁰

The problems with bankruptcy's current undifferentiated rules stem largely from the classic differences between close and publicly held corporations. Publicly held corporations are characterized by a separation of ownership and control, with professional managers running the corporation and widely scattered shareholders as its nominal owners.¹⁷¹ By contrast, closely held corporations frequently have a small number of shareholders, most or all of whom also participate in the management of the firm. The shares of a closely held firm are not traded on a public exchange and are frequently subject to restrictions on transfer.¹⁷²

How should the Bankruptcy Code be reformed to better reflect these differences? One approach would be to employ the American Law

presumably participate less actively in a case where unsecured creditors are not likely to recover anything. Second, and more importantly, if unsecured creditors' interests are clearly under water, a better solution would be to grant the secured creditor relief from the automatic stay, and to allow the secured creditor to determine how best to make use of the assets of the firm.

167. Skeel, *supra* note 18.

168. *Id.* at 505-13.

169. *Id.* at 495-501.

170. Unsecured creditor voting on directors is less attractive in the context of closely held firms, because jeopardizing the debtor's role as director or owner is likely to mean the end of the corporation in its current form. The problem with unsecured creditors voting on preconfirmation sales of assets is that unsecured creditors often are not the optimal decision makers with respect to a closely held Chapter 11 debtor. Because many closely held debtors are fully encumbered and their secured creditor undercollateralized, secured creditors may frequently be the residual class in this context. See, e.g., Skeel, *supra* note 18, at 497 n.134.

171. See, e.g., ROBERT C. CLARK, CORPORATE LAW 359-60 (1986).

172. *Id.* at 24-28.

Institute's strategy outside of bankruptcy—a strategy shared by a number of states—of adding “close corporation” and “publicly held corporation” to the definitional section of the Code, and then referencing these definitions in provisions that apply to a specific kind of corporate debtor.¹⁷³ Such an approach would prove unsatisfactory in the bankruptcy context, however. Because the provisions of Chapter 11 comprise an elaborate corporate governance framework, many of whose sections function differently for different kinds of corporations, the changes needed are too extensive to be addressed in piecemeal fashion.

Rather than following the ALI approach, then, the drafters should establish entirely separate chapters for closely held and nonclosely held debtors.¹⁷⁴ As the discussion above indicates, the close corporation chapter should alter the current committee structure to provide for a single creditor agency arrangement, whereas nonclosely held corporations might continue to use the extant rules for committee formation. Similarly, the proposals for unsecured creditor voting on directors and preconfirmation sales should be adopted in the nonclosely held corporation chapter, but not for closely held firms.

The drafters also could address problems with respect to two other important aspects of corporate reorganization in connection with the move to a two chapter system. Both reforms would pressure the parties to reorganize more quickly and, as a result, would decrease both the direct costs—lawyers and other professionals charge less in a twelve month case than in a two year case—and the indirect costs of bankruptcy.

The first deals with the debtor's agenda control over the reorganization process. Under the Bankruptcy Code in its current form,

173. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: PROPOSED FINAL DRAFT, Part I (Mar. 31, 1992) [hereinafter ALI, PRINCIPLES OF CORPORATE GOVERNANCE]. The ALI defines a debtor with a small number of shareholders and for which no active trading market existed prior to bankruptcy as a “close corporation debtor.” The existence of 500 or more shareholders and at least \$5 million in total assets meets the standard for being publicly held. *Id.* § 1.31. The ALI definition of publicly held corporations is derived from various sources, including Securities Exchange Act of 1934 § 12(g) and Rule 12g-1, and Federal Securities Code § 402a. The ALI also has specific definitions for “Large Publicly Held Corporation,” ALI, PRINCIPLES OF CORPORATE GOVERNANCE, *supra*, § 1.24, and “Small Publicly Held Corporation.” *Id.* § 1.35.

174. The distinction between close and publicly held corporations leaves out a large class of firms that fall between these two extremes. Because closely held firms differ far more from either publicly held corporations or this intermediate class of firms than the other two types of firms differ from one another, closely held firms should have an entirely separate chapter. The other chapter would comprise all corporations that do not fit this definition and thus are “nonclosely” held. A more precise breakdown might make further distinctions among nonclosely held firms (as the ALI does), but the benefits of the added precision do not seem significant enough to warrant such a step.

the debtor in possession alone has the right to propose a reorganization plan for the first 120 days of a bankruptcy case.¹⁷⁵ This initial exclusivity period is not itself a problem—the rule focuses the parties' efforts and vests authority in the only party that is fully familiar with all aspects of the firm.¹⁷⁶ But courts routinely extend exclusivity, particularly in cases involving publicly held firms.¹⁷⁷ Unfortunately, these extensions give the debtor an indefinite stranglehold over the plan process in many cases, and exacerbate the incentives a debtor already has to slow the reorganization process.¹⁷⁸ The problem could be substantially reduced if the drafters were to impose a fixed limit on the length of the debtor's exclusivity period. Increasing the exclusivity period to 180 days, but prohibiting extensions, for instance, would afford a nonclosely held debtor sufficient breathing space and at the same time increase the pressure to develop a plan quickly. Because the negotiations involving closely held firms are frequently less complex, the drafters could adopt a shorter, but equally fixed, exclusivity period such as ninety days for closely held firms.¹⁷⁹

Given courts' frequent effectiveness in policing opportunistic behavior, one might wonder why the drafters need to propose a legislative solution to the exclusivity issue; that is, why do courts themselves not impose appropriate limits? The problem apparently is that courts are largely unable to credibly commit to terminating exclusivity at the end of

175. Bankruptcy Code § 1121.

176. Bradley Johnston has pointed out another advantage of exclusivity: It ensures the existence, at least initially, of a "single negotiating text." J. Bradley Johnston, *The Bankruptcy Bargain*, 65 AM. BANKR. L.J. 213, 270 (1991). Starting with a single plan rather than several conflicting proposals simplifies and coordinates the bargaining process. HOWARD RAIFFA, *THE ART AND SCIENCE OF NEGOTIATION* 211 (1982) (single negotiating text used in the negotiations between Begin and Sadat to focus the parties' attention on a single document).

177. LoPucki & Whitford, *Bargaining over Equity's Share*, *supra* note 10, at 28.

178. Note that these incentives are particularly problematic when the managers are aligned with shareholders, since they will want to prolong the case and take risks so as to increase the likelihood shareholders will end up with something. *See, e.g.*, Jackson & Scott, *supra* note 19, at 170.

179. After this article was written, the House passed bankruptcy legislation that would have limited exclusivity to one year (and also deleted a proposed new chapter that included a ninety day limitation for close corporations). H.R. 6020, 102d Cong., 2d Sess. § 102 (1992). While I prefer a 180 day limitation (and also have some reservations about the proposal's escape hatch, which would have permitted extensions if "the need for such an increase is attributable to circumstances for which the debtor should not justly be held accountable"), the one year limit would have improved upon current law had the legislation not eventually died. I discuss the legislation in more detail, *infra* Section IV.B.

the current 120-day period.¹⁸⁰ The debtor, as well as the other parties, knows that the court will extend exclusivity if the parties have made progress toward a confirmable reorganization plan; the debtor therefore has little incentive to hasten the reorganization process. While a bankruptcy judge could announce at the beginning of a case that she does not intend to extend exclusivity, the debtor has little reason to believe that she will not change her mind if, at the end of the initial period, the parties appear to need just a week or two more to conclude their negotiations.¹⁸¹ Legislative commitment to a fixed exclusivity period eliminates these problems by making a court's threat fully credible.

Second, the drafters could adjust the confirmation requirements of the nonclosely held corporation chapter to curb the hold up power currently wielded in that context by the shareholders of a Chapter 11 debtor. Under the current Bankruptcy Code, the parties have a strong incentive to pass a consensual reorganization plan, despite the facts that consensual reorganization requires voting approval of every class of claims or interests and, further, that the Code provides for confirmation of a nonconsensual, "cramdown" plan.¹⁸² Consequently, even though shareholders theoretically have little or no financial interest in an insolvent firm, the plan proponent must secure their approval in order to confirm a consensual plan. Shareholders frequently use the veto power that the process gives them to delay the case.¹⁸³ To address this

180. The problem is exacerbated by bankruptcy judges' desire to encourage high profile debtors to file for bankruptcy in their courthouse. Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WIS. L. REV. 11, 13.

181. Courts' inability to make a credible commitment or threat in this context stems from their lack of a direct stake in the outcome of the case. Because they lack a direct interest, courts cannot easily provide a "hostage" or otherwise commit themselves to a particular course of action. See generally Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983).

182. Bankruptcy Code § 1129(a)(8) requires, for a consensual plan, that each class that is impaired vote in favor of the plan. The requirements for a nonconsensual plan, the most important of which is the absolute priority rule, are set forth in Bankruptcy Code § 1129(b). Due to the expense and uncertainty of the valuation required under Bankruptcy Code § 1129(b), both the parties and courts are strongly predisposed toward consensual reorganization. LoPucki and Whitford argue that the attorneys' status as repeat players who will encounter one another again in future Chapter 11 cases is also a crucial element in this calculus. LoPucki & Whitford, *Bargaining over Equity's Share*, *supra* note 10, at 143-58.

183. Strategic behavior of this sort appears to have played a key role in the collapse of an auction in the bankruptcy of Allegheny International. Donaldson, Lufkin & Jenrette Securities twice seemed to have won the auction, but the debtor reopened the bidding on both occasions after heavy pressure from the firm's shareholders to consider new offers by the other bidder, Paul Levy. The Paul Levy bids did not appear to offer

problem, the drafters should amend § 1129, the confirmation provision, to provide in the nonclosely held firm context that, if a plan is approved by every class except the firm's shareholders, the court must approve the plan if the firm appears to be insolvent as of the time of the vote. This partial cramdown, a variation of LoPucki and Whitford's recent "preemptive cramdown" proposal, would significantly reduce the duration of cases in which shareholder opportunism is the primary impediment to timely reorganization.¹⁸⁴ While partial cramdown theoretically is possible under the current Bankruptcy Code, adopting it explicitly would effectively counter the parties' current reluctance to utilize this alternative to consensual reorganization.

As with unsecured creditor voting on directors and preconfirmation sales, partial cramdown is less attractive for closely held firms, whose shareholders and managers are the same people. If the corporation is deeply insolvent, it may make more sense for the court to grant relief from the automatic stay for the primary lender.¹⁸⁵ On the other hand, for those close corporation cases where reorganization is at least plausible, the drafters could consider adopting a variation of the new value exception to the absolute priority rule, which permits shareholders to retain an interest in the reorganized company over the objections of creditors, even if the creditors will not be paid in full.¹⁸⁶ While the exception is entirely inappropriate for nonclosely held firms (and is rarely used in that context), a case can be made for its inclusion in modified form in a chapter limited to closely held debtors.¹⁸⁷

superior value; rather, their salient characteristic was that they proposed a particularly generous treatment of shareholders. The value of the firm fell precipitously after the auction collapsed. See, e.g., Clare Ansberry, *Takeover Mayhem: When Will Somebody—Anybody—Rescue Battered Allegheny?*, WALL ST. J., Apr. 19, 1990, at A1.

184. LoPucki & Whitford, *Bargaining over Equity's Share*, *supra* note 10, at 186. LoPucki and Whitford argue that, if the debtor is so clearly insolvent that there is no possibility shareholders will be entitled to a distribution, courts should make a finding early in the case effectively excluding shareholders from the case. The problem with this proposal is that early in the case courts will be excessively optimistic about the possibility of a recovery for shareholders, rather than risk being proven wrong by subsequent events. The advantage of the partial cramdown proposal is that it comes at a time in the case when the debtor's value is much more clear, and the threat of strategic behavior is particularly acute.

185. See *supra* note 166.

186. David A. Skeel, Jr., *The Uncertain State of an Unstated Rule: Bankruptcy's Contribution Rule Doctrine After Ahlers*, 63 AM. BANKR. L.J. 221, 223 (1989).

187. See Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69 (1991). Markell argues that shareholders should retain their right to participate in the new value context, but only if the potential for abuse is controlled through several important changes in the reorganization process. In particular, in order to neutralize the shareholders' procedural advantage, Markell

Needless to say, the two reorganization chapters will overlap in some respects. Both should retain the assumption that current managers will continue to operate the business in bankruptcy, for instance.¹⁸⁸ But more carefully tailoring the bankruptcy process to account for differences between closely held and publicly held corporations would greatly improve the process, and change could provide a means of addressing many of the problems that currently plague Chapter 11, such as administrative inefficiency and the frequent failure to put decision-making authority in the hands of the constituency most likely to wield it effectively.

*B. The Failure Last Time: Chapters X and XI of the
Bankruptcy Act*

One potential objection to the proposed shift to a two corporation regime might suggest, in effect, that the drafters have already tried this strategy and it did not work. To appreciate the objection, it is necessary first to consider briefly the structure of the former Bankruptcy Act.

Under the Act, the drafters developed separate chapters for publicly held corporations and nonpublic firms. Chapter X, the chapter for publicly held firms, provided for replacement of management by a trustee, required strict adherence to the absolute priority rule, and was only available to firms whose debts exceeded \$3 million.¹⁸⁹ By contrast, Chapter XI permitted the firm's managers to stay in charge, prohibited modification of the firm's secured debt, and did not condition reorganization on preservation of absolute priority.¹⁹⁰

advocates that the exclusivity period be terminated as soon as an equityholder proposes a new value plan, that the Bankruptcy Code should not require the proponent of a competing plan to prove the "reorganization value" of the firm, and that a court should confirm the competing plan (rather than the equityholder's plan) if the parties vote in favor of both it and the new value plan. *Id.* at 112-21. Even in this modified form, the exception would only be attractive if courts were willing to confirm liquidating plans or grant relief from the stay in the event the debtor is hopelessly insolvent. See generally Skeel, *supra* note 186 (criticizing the exception as currently applied).

188. Bankruptcy Code § 1107. In the nonclosely held firm context, immediate removal of management would create significant indirect costs both before and during bankruptcy. Prior to bankruptcy, managers would stall as long as possible rather than file a bankruptcy petition and immediately lose their jobs. During bankruptcy, immediate replacement of management with a trustee would add to the distractions of the process, since the trustee would be unable to focus on business affairs until she familiarized herself with the firm. With respect to close corporations, because the managers are both the shareholders and an integral part of the identity of the firm, ousting them would all but eliminate the benefits of bankruptcy for such a debtor.

189. 1973 COMMISSION REPORT, *supra* note 118, at 244-48.

190. *Id.*

The Act scheme proved a colossal failure. The managers of publicly held firms took advantage of Chapter XI's failure to explicitly exclude these firms, and filed under Chapter XI so that they could retain control of the company and would not be hamstrung by the absolute priority rule. Pitched, and costly, battles arose as to whether this was a permissible jurisdictional choice.¹⁹¹

While the experience with Chapters X and XI illustrates some of the risks of a context-specific approach, it ultimately does not undermine the case for a two corporation system. First, and most obviously, the proposed reforms outlined above do not suffer from the specific flaws that doomed the Act regime. The proposal would preserve the current Code's presumption that the present managers will stay in office for both chapters,¹⁹² therefore eliminating the considerable forum-shopping incentives created by a framework that automatically removes managers in one context but not another. Clearly defining which chapter applies to a particular debtor would further diminish the likelihood of costly manipulation.

The more important problem with the Act framework, however, was simply that Chapter X took the drafters' concern for state involvement in the bankruptcy process several steps too far. With the lessons of the Act still relatively fresh, Congress almost certainly would avoid these mistakes in crafting a more context specific Code, and might redress at least the most obvious of the problems with an undifferentiated insolvency regime.

C. Pending Bankruptcy Legislation: The Proposed New Chapter 10 for Small Businesses

Congress recently recognized the need for separate close and nonclosely held corporation chapters, and considered new bankruptcy legislation which initially proposed that a special chapter for small business debtors be temporarily added to the Bankruptcy Code.¹⁹³ The new chapter, Chapter 10, would have applied only to "small businesses,"

191. *Id.* at 247.

192. *See supra* note 188.

193. S. 1985, 102d Cong., 2d Sess. § 205 (1992). The bill passed the Senate in June, 1992. In October, 1992, the House passed its own version of the legislation. *See supra* note 179. The House version omitted the proposed new chapter for small debtors (and added various new provisions), as did the reconciled version that ultimately stalled in the House. The discussion in the text focuses on the proposed chapter for small debtors, as set forth in § 205(c) of the original Senate bill, and which is likely to reappear in some form in future legislation. Hereinafter, provisions of the proposed new chapter, will be cited as "Proposed Chapter 10 § ____." For a brief chronology of the legislative process, see David F. Bantleon & Kathy L. Kresch, *A Bankruptcy Law for the '90s*, BUS. L. TODAY, Jan.-Feb. 1993, at 25.

which the legislation defined as debtors "whose aggregate liquidated secured and unsecured debts as of the date of the petition do not exceed \$2,500,000."¹⁹⁴ The legislation appeared to contemplate that a disinterested trustee rather than a creditors' committee would represent creditors' interests, since the United States Trustee would appoint a trustee, but not necessarily a committee, in every case.¹⁹⁵ The drafters intended to require that debtors file a plan within ninety days, thus addressing the exclusivity problem,¹⁹⁶ and would have permitted small businesses to violate absolute priority so long as the plan in question "provides that all of the debtor's projected disposable income to be received in the 3-year period . . . will be applied to make payments under the plan."¹⁹⁷

The proposal in some respects addressed precisely the problems we have identified with Chapter 11's current network of undifferentiated rules. In addition to the important step of recognizing the need for a special close corporation chapter, the legislation would have shortened the close corporation exclusivity period in exactly the fashion that I have advocated. Unhappily, each of the other choices the drafters have made for close corporations was questionable at best and potentially counterproductive.

First, the legislation's definition of "small businesses" as debtors whose liabilities do not exceed \$2,500,000 raises several problems. As the analysis above has shown, the definition should focus upon the number (or more precisely, concentration) of shareholders, not simply on the amount of liabilities, since shareholdership is a far more important variable in distinguishing close from nonclosely held debtors.¹⁹⁸ A better definition might have emphasized the number of shareholders and the absence of public trading of the shares, as the ALI and some states do outside of bankruptcy.¹⁹⁹ If the drafters did wish to retain a liability

194. Proposed Chapter 10 § 1001 (permitting "small business" debtors, as defined in § 205(a) of the bill, to invoke the proposed new chapter). An earlier version of the bill would have left "small business" debtor largely undefined, suggesting only that the court should determine whether a debtor's use of proposed Chapter 10 would serve the best interests of the estate. The drafters' decision to revise the definition clearly was a good one, given among other things the threat of a reintroduction of the jurisdictional maneuverings of the old Bankruptcy Act.

195. Proposed Chapter 10 § 1003.

196. Proposed Chapter 10 § 1021.

197. Proposed Chapter 10 § 1026(b).

198. See *supra* notes 171-74 and accompanying text. Congress appears to have mistakenly assumed that the real distinction between types of corporations relates solely to volume of business. In actuality, volume of business is only a partially accurate proxy for the more important differences in shareholdership and corporate governance structure.

199. See *supra* note 173.

limitation on access to the chapter, however, they should have significantly increased the \$2,500,000 ceiling, as many close corporation debtors have liabilities far greater than this amount.

Second, the substitution of a trustee in place of a creditors' committee might have improved on the current regime but would probably have proved far less effective than the single creditor committee that I have proposed. The problem with the trustee approach, aside from the caseload burdens that already plague the U.S. Trustee system, is that the governmental observer is at best an objective representative (and one who, unlike a creditor, would have no familiarity with the debtor at the start of the case). Unsecured creditors would be better off if someone who has the same financial interest that they have represents them.²⁰⁰

Finally, the drafters' proposal to require confirmation of plans that dedicate all of the debtor's projected income for the following three years to its current creditors would have given far too much flexibility to small business debtors. While retention of a limited version of the new value exception to absolute priority merits consideration in this context, as I have suggested,²⁰¹ the new legislation goes well beyond this, affording many debtors whose situation is in reality hopeless the ability to reorganize so long as they promise to pay a hypothetical amount of future income under the plan. The effect of the legislation in many cases would be simply to postpone further the inevitable liquidation. As a result, the drafters' decision to import Chapter 13's "fresh start" policy for individuals into the very different context of corporate debtors would have increased the cost of credit for all debtors,²⁰² since creditors would charge higher interest rates to offset the unnecessary new costs created by the new regime.

In short, in its existing version, the proposal to add Chapter 10 to the Bankruptcy Code would have created at least as many problems as it might have solved. But Congress's recognition of the need to distinguish close corporations from nonclosely held firms offers at least a glimmer of hope that the widespread conviction that Chapter 11 is not working will lead to more promising changes in the current insolvency regime when Congress tries its hand again in upcoming legislative sessions.

200. See, e.g., Rock, *supra* note 108, at 503 n.220 (similar problem with proposals to appoint a judicial committee to decide whether shareholders' derivative suits should be pursued).

201. See *supra* notes 186-87 and accompanying text.

202. Cf. Bankruptcy Code § 1325(b) (confirmation provision nearly identical to Proposed Chapter 10 § 1026(b)).

CONCLUSION

Corporate bankruptcy reform in this country has in the last century occurred at roughly forty year intervals. Thus, Congress enacted new corporate bankruptcy laws in 1867, 1898, 1938, and 1978. Recent dissatisfaction with the current Bankruptcy Code is sufficiently acute that a proposal to overhaul all aspects of the Code nearly passed Congress this year, less than fifteen years since Congress's last effort at reform.

A growing number of commentators do not believe that simply reforming the corporate reorganization provisions is enough and contend that the time has come to replace Chapter 11 with an entirely different insolvency framework. Unfortunately, none of the current proposals adequately balances the desirability of more cost effective proceedings and less judicial intervention in asset deployment decisions, on the one hand, with the importance of judicial involvement for monitoring and discovery purposes, on the other.

This does not mean that Chapter 11 should be retained in anything like its current form, however. Given Chapter 11's major shortcomings, a context-specific, market-oriented proposal that also provided a measure of judicial oversight would warrant serious consideration. If, on the other hand, Chapter 11 remains in place, it should be radically reformed. This Article argues for the creation of separate chapters for close and nonclosely held corporations, in order to begin the transition to a regime with far more context specific rules.